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INVESTMENT USES OF LIFE INSURANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

MARCH 15, 1988

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INVESTMENT USES OF LIFE INSURANCE

TUESDAY, MARCH 15, 1988

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
THURSDAY, FEBRUARY 18, 1988

PRESS RELEASE #9
SUBCOMMITTEE ON SELECT
REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE
BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL, (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A PUBLIC HEARING ON INVESTMENT USES OF LIFE INSURANCE

The Honorable Charles B. Rangel, (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing on Tuesday, March 15, 1988, on the investment uses of life insurance, beginning at 10:00 a.m. in room B-318 Rayburn House Office Building.

The hearing will focus on whether the Federal income tax treatment of certain life insurance contracts is appropriate under present law. In 1984, Congress adopted a definition of life insurance for Federal tax purposes in order to ensure a minimum level of life insurance protection relative to the investment orientation of a life insurance policy. However, the Subcommittee is concerned that the present statutory definition may not be curtailing the purchase of life insurance principally as an investment or as funding for consumer purposes rather than, as intended in the 1984 legislation, a means to provide death benefits for dependents.

The Subcommittee intends to analyze the current uses of life insurance policies, particularly single-premium policies and other policies marketed primarily as investment vehicles, and to consider whether the present-law tax treatment of life insurance is appropriate in light of these uses.

Additionally, the Subcommittee will explore whether proposals are appropriate to limit the use of life insurance as an investment vehicle without discouraging the purchase of life insurance as a means to provide death benefits for dependents. The Subcommittee encourages interested parties to testify on alternatives for any modification of the tax treatment of life insurance. In this regard, the Subcommittee invites testimony on H.R. 3441, a bill introduced by Congressman Fortney H. (Pete) Stark (D., Calif.), a member of the Subcommittee, and cosponsored by Congressman Bill Gradison (R., Ohio) a member of the Committee, that would alter the Federal income tax treatment of loans and other pre-death distributions from life insurance contracts, as well as any other proposals addressing these issues.

The Treasury Department is expected to be the first witness. Public testimony is invited.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-1721] no later than Friday, March 4, 1988, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearings. See formatting requirements below. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements to the Subcommittee office, room 1111 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies of their statements by the close of business, Tuesday, March 29, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1111 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing may be submitted in other forms.

* * * * * * * * *

* NOTICE--CHANGE IN LOCATION *

FOR IMMEDIATE RELEASE
THURSDAY, MARCH 10, 1988

PRESS RELEASE #9-REVISED
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-9710

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A CHANGE IN LOCATION OF THE MARCH 15, 1988, SUBCOMMITTEE HEARING ON THE INVESTMENT USES OF LIFE INSURANCE

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced a change in location of the hearing scheduled for March 15, 1988, on the issue of investment uses of life insurance. The hearing will be held in the main Committee hearing room, 1100 Longworth House Office Building, not B-318 Rayburn House Office Building as originally announced.

All other details concerning the hearing remain the same. (See Press Release #9, dated February 18, 1988).

*****

Chairman **Rangel**. We will be delayed. Someone said the court reporter has blown a fuse. I guess they meant that something is wrong with the equipment.

The Subcommittee on Select Revenue Measures will come to order. We will have our hearings on the single premium and other areas of life insurance policies. I would like to welcome everyone this morning.

We have read many ideas in business commentaries reflecting the tax shelter possibilities of certain insurance policies and today we will actually have testimony which will give us the specifics on the type of policies that we will look into. From the basis of the testimony we anticipate that we will have enough information upon which to judge whether the goals of the Congress in allowing funds to be set aside tax-free in insurance policies are being met with respect to certain insurance policies.

We further anticipate that we will have enough information today from which we will be able to formulate an appropriate legislative response, if those goals are not met by the investment-oriented type of policy. If there is abuse, the committee feels a responsibility, indeed, and has been directed to eliminate that abuse.

With us today is one of my colleagues that has spent so much time in this field and preceded me as chairman of this subcommittee, and who certainly earned the reputation, if not in this Congress, among the industry in being a very fair. He has weighed the goals that the Congress related to this specific type of policy. He represents a view that is respected in the industry as well as in the Congress, and we will be leaning on him throughout in the formulation of the new legislation.

And I am convinced we will have new legislation. Of course, I am referring to Pete Stark.

STATEMENT OF HON. FORTNEY PETE STARK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. **Stark**. Thank you, Mr. Chairman.

I am about to blow that all away this morning. Members of the committee and I have talked with advocates of various branches of the industry, and I would like to say a couple things very quickly this morning.

I am not sure that I can define abuse. Is deductibility of home owner's mortgage an abuse or a large expenditure of tax dollars? I guess that depends on whether you are in the home building industry or not.

Single premium life insurance, if you don't all understand it, just very quickly, it is just one of the variety of labels that we put on life insurance. All insurance, like all aspirin, is alike. You package it differently, put a different label on it and mix it with a few other compounds and either sell it as a high markup or in a generic variety at a very low cost.

Some insurance is packaged with investments of all kinds, some is traditional savings investment and some comes with all kinds of bells and whistles, and you pay more money over different lengths of time. You all have charts like this with yellow colored in. I am not sure the staff has the yellow. It just attempts to show you how inside buildup relates to different kinds of policies.

The last one, the one titled, "Whole Life Policy", probably has the lowest amount of inside build-up in the illustration and comes closest to what we had in mind in the 1984 act, and even that is probably a little generous in allowing tax-free accumulation of income in a policy. That is pretty much what single premium life is. It is a combination of investments and protection designed and sold under the guise of tax savings, for the most part.

It is mostly sold in high sales volume at a very low sales cost compared to the more traditional policy at a high sales commission. What is the problem? I suspect it is a problem in the Treasury. As near as we can tell, there is maybe $200 billion of cash value in existence today. Give them 6 or 7 percent earnings on that and I expect there are billions at least of the total taxable income which the Treasury doesn't get their cut out of. That is the entire insurance industry.

Single premium sales are for the most part, all cash value, unlike premiums of a lot of other products, with the first a couple years of premiums going to sales commissions. Single premium starts to pay for the insurance and it pays into cash value fairly fast.

Single premium is all cash value for the most part. Over the last three years, single premium sales have gone roughly from $1 to $5 to $10 billion a year, so that in 1987, single premium life equaled all other life insurance sales, and that is a super rapid growth. There is now about $18 billion in cash value that the ads will show you or, and I am inclined to believe, were put there not for protection, but largely put there as a tax shelter investment.

It is pretty rapid growth, maybe $100 to $300 million in lost revenues, depending on the effective rate and how much of that money might go into municipal bonds. Is there a problem today? I don't know. That is for the committee to decide. Will there be a problem if you get this kind of growth rate? Absolutely. We will be losing revenue hand over fist.

So, there is a problem for the Treasury in both actual lost revenue and another problem is for the industry, and others. Interindustry, stock brokers, savings banks, the insurance industry, are all competing for the same dollars. Suddenly stock brokers are cutting into the insurance industry's turf. That creates a problem for certain types of insurance salesmen.

You are hearing from both sides of that issue. This is a problem for them. The interindustry problem is largely between the old rivals of the stocks and mutuals and the new ideas. There is no real unity in the industry. They are running higgledy-piggledy trying to put together a policy, but I suspect that the testimony today will show they are not very close to that.

If the committee decides there is a problem, then solving the problem, it seems to me, takes a couple things we ought to remember. We have to solve the problem fairly. That goes without saying and that is going to be very difficult because you can't have both ends teeter totter in the air at the same time.

I would submit to the committee, and we have passed out some other handouts that show various advantages that are available under IRA's and Keoghs and 401(k)'s and life insurance. Very little IRA money and Keogh money went into life insurance in the good old days.

Now, with the absence of IRA's, a lot is going into insurance that is probably not as good a deal because insurance sales costs are generally higher than mutual funds and savings banks. We have always in the life insurance tax area, when we are talking about taxing the product, talked about keeping the playing field level so as not to tilt it between stock brokers or savings banks or insurance companies.

Another part of the solution might be limiting the aggregate amount. We do that in pensions, we did that in 401(k)'s, IRA's. We decided the problem is getting pretty big. We ought to limit it according to the individual tax payer. I have a hunch the insurance industry would dislike that solution very much. But, it is something we ought to consider.

If we are going to allow a certain kind of tax exemption for a certain product, for whatever reason we decide, maybe we ought to put some limit on how much one taxpayer can buy, because as you can see, why we are here today and what triggered these hearings is to see something go from $1 to $5 to $10 million, all of which basically is investment in tax avoidable or tax sheltered investments.

That is the smoke which portends there may be a fire that this committee will want to start to put out. I would be glad to talk with any of you on any particular questions you have, and I am sure you are anxious to get on with the hearing.

Chairman RANGEL. Before I entertain questions, I would like to take this opportunity to put into the record, by unanimous consent, a statement from the ranking minority member, Mr. Vander Jagt, if there is no objection. And also to ask whether or not there are any opening statements any member of the subcommittee would like to make.

[The statement follows:]

STATEMENT OF HON. GUY VANDER JAGT, RANKING MEMBER OF THE SELECT REVENUE MEASURES SUBCOMMITTEE

Mr. Chairman. I firmly believe that the current law treatment of cash value life insurance serves very important social policy and national economic goals. Cash value life insurance contributes to the national savings rate, a particularly important goal in view of the deterioration of our long-term savings rate over the past couple of years. Additionally, the purchase of cash value life insurance serves an important social policy goal of providing much needed death protection.

Recently there have been concerns raised about the use of single premium cash value life insurance policies. Suggestions have been made that the use of this type of policy represents an abuse that requires legislative action. This concern has been largely fueled by irresponsible advertising by a small group of companies. This irresponsible advertising has created a number of incorrect perceptions with respect to the nature of single premium life insurance. For example, many believe that single premium life insurance policies provide low amounts of death benefits, with very large premiums, that are only purchased by wealthy persons, particularly in the young professional category. In addition, many believe that most purchasers of single premium policies borrow significant portions of the cash value of their policies. The relevant facts indicate that these perceptions are incorrect. A survey of the 25 companies who have sold approximately three quarters of the single premium life insurance policies issued in 1987 reveals the following:

The average death benefit of a single premium life insurance policy is approximately $81,000. By way of comparison, the average ordinary life insurance policy sold in 1986 had a death benefit of approximately $60,000.

The average premium for a single premium life insurance policy is approximately $29,600, and 66 percent of single premium policies are purchased with a premium of less than $25,000. This premium pays for a lifetime of insurance protection and is substantially less than the premiums required to purchase the same death benefit on an annual premium basis.

In a survey by one company, it was determined that 80 percent of the company's single premium policyholders had taxable incomes of less than $60,000.

Approximately 70 percent of single premium policies are purchased by individuals age 50 or older and a commonly cited reasons for the purchase is to provide family security.

Only 7.3 percent of single premium policies have a policy loan.

The total amount of single premium policy loans is only 3.7 percent of single premium policy cash values.

When these facts are considered, it is apparent that the single premium "problem" is primarily a problem of perception, not reality. I believe that the Committee should carefully consider the actual facts and the important role that cash value life insurance plays from both the national savings perspective and the social policy perspective in considering any possible change. It is my own view that current law is working fairly well and should not be modified in any significant manner.

Chairman RANGEL. Mr. Brown.

Mr. BROWN. Mr. Chairman, thank you.

I appreciate the gentleman from California's comments this morning. He is obviously very bright and well informed on this issue. It is natural that various members of the committee would have different views on this particular area. I do understand that a particular type of insurance—single premium—had led to additional sales, and some view the additional savings offered by single premium policies as a problem.

Others of us think that these savings, in the form of capital formation may well be one of the best things that could happen and we probably ought to be thinking about how we can encourage more of it instead of less of it.

The one point I would like to make is that if we change the rules, that we grandfather existing contracts. I think this is the fairest way to deal with existing policyholders.

Chairman RANGEL. This is not for the purpose of response. I just want to give the committee members an opportunity to make a brief opening statement and then, of course, we would like the response.

Mrs. KENNELLY. Thank you, Mr. Chairman. Thank you for holding these hearings. A number of us on the current subcommittee worked together quite hard on the life insurance tax provisions of the 1984 Deficit Reduction Act. In fact, we worked very well under the leadership of our witness right now, Mr. Stark.

As a result of that effort, we created two statutory tests which define life insurance and, therefore, eliminated certain policies we considered to be too investment oriented. This is the same situation that we are looking at today, the same question.

I think concerns have been raised that warrant this hearing. Since that time, Mr. Stark has so well said, the 1986 tax reform has changed the tax world in many ways. The explosive growth in single premium life insurance which occurred at the same time as sales of ordinary life insurance held comparatively steady, does raise questions which need to be answered by these hearings.

And the purpose of this hearing is to get those responses on record, so the subcommittee members can determine for themselves what course of action should be taken. I would like to mention right up front, Mr. Chairman, that the flip side of this coin is that if an explosive growth in sales raises questions about the tax treatment of single premium products, so too the relative stability in the sales of other types of life insurance products must confirm the appropriateness of their present treatment and that is exactly what we did when we were looking at the 1984 act.

I think we should look at that as well and not just look at single premium, but remember that all those other insurance policies have, in fact, resulted in exactly what we wanted in 1984. Again, Mr. Chairman, I thank you very much for these hearings.

Chairman RANGEL. Thank you. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman. I welcome our colleague, Pete Stark, to these hearings. We have been looking forward to these hearings for a long time.

I am delighted that we are having these hearings to find out whether or not, in fact, all of what has been said about these policies, all the abuses, so to speak, are true or not.

Let me support what Mrs. Kennelly said about the insurance industry as such. There are, I guess, some perceived abuses out there regarding this particular product of the life insurance industry. I would hope that these hearings and whatever remedy we decide to correct those abuses, real or perceived, would not throw out the baby with the bath water.

We have an industry out there that has been a long time contributor to our economy, both in terms of making loans and in creating millions of jobs throughout this country. I would hope that we don't effect those other kinds of products of this industry by being overzealous in our efforts to curb some abuses in perhaps one product.

I would also support the views of my colleague from Colorado, Mr. Brown, that any solution we might come up with at this particular time not be retroactive. I think we ought to define what retroactive means, that is, whether or not it is all old contracts or contributions, or only certain ones.

I am looking forward to this hearing to find out whether or not what we have been reading and hearing in the advertisements regarding single premium policies is real or not.

Thank you.

Chairman RANGEL. Mr. Gregg.

Mr. GREGG. Thank you, Mr. Chairman.

I also am looking forward to this hearing. There are some fascinating issues raised here. I hope as a committee we will concentrate not on making our decisions based on revenue driven considerations, but on tax policy considerations.

I believe this hearing gives us an opportunity to address really significant tax policy considerations. Specifically, whether or not we want a tax law which encourages consumption or savings, to what extent we want to encourage savings, what type of savings we want to encourage and the relationship between certain types of savings and capital formation.

I think those are the tax policy considerations and issues we should take up.

Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Stark, your legislation, H.R. 3414, is it targeted to eliminate perceived abuses with single premium or does that legislation intend to address the much larger issue as it relates to inside build up?

Mr. STARK. Mr. Chairman, it does indeed cover a broader issue because single premium is only one permutation of thousands of different types of policies that can be sold. It attempts to pick the best of no perfect solution.

There are two or three approaches and I think that is about all, to limiting the use of an insurance contract to enjoy current tax exempt income while having a great deal of investment flexibility and, indeed, a personal investment portfolio.

The change in distributional rules and the penalty for withdrawal would effect, indeed, any new contract that, if I might at this point, I think I can speak for Mr. Gradison and myself, we have no interest in making this retroactive. There is some question about new money in old policies but, basically, all old money would enjoy its present protection. And we, too, think that retroactivity should not take place just to put peoples' minds at ease. But it would effect withdrawals of cash value from other policies, and it would put insurance policies on a par with, say, annuities or other tax-sheltered savings programs in that when you withdraw the money, you withdraw income first and principal after that. That is what we do on every other type of withdrawal that is taxed.

This would help Mr. Gregg's concern. It would tend to keep money into savings, rather than allowing people to withdraw it systematically for current consumption. Whether that is a way to do it or not, the committee can decide, but to solve the problem it was our feeling along with the staff's concurrence, that we had to address the problem generically and address the policies.

There is a definitional approach to this as well, but as we found as a result of the 1984 act, under the definition, you can package insurance and investments to gain the system somewhat more easily than dealing directly with the manner under which you accumulate inside build up. That is to say you keep it until you are 59½ for retirement, and I think one of the suggested amendments that we find attractive is that you say you also keep it for 15 years, so people buying these types of products for college education or long-term savings, say you have met the goal of getting some tax sheltering by keeping it 15 years or to the age of 59½, whichever occurs first, and you can put all kinds of whistles and bells on it, but it seemed to us that that was a better way to solve the problem.

Chairman RANGEL. And so it is safe to say that you and our colleague, Mr. Gradison did not introduce this legislation to pinpoint the perceived abuses in single premium, but this is an extension of what both of you consider to be a reform of the inside insurance build up.

Mr. STARK. The largest impact of this one is on the single premium product, and it would then be equally as tough, say on 3 payment, 5 payment life. On 20 payment life its effect would tend to be reduced. On the ordinary contract that is paid for generally until mortality, it would have a minimal effect. As I say, it was brought to our attention and obviously the reason for doing it was the rapid growth of single premium and the ads which called to our attention the offering of insurance as a tax sheltered investment rather than as insurance.

Chairman **Rangel**. You are prepared to say that if we did not have this perceived problem in inside build up, you would think that the effect of those legislative recommendations would improve the insurance system generally outside of single premium?

Mr. **Stark**. If we didn't have the problem of single premium, the only thing I think would happen is 4 or 5 years from now we would have some pressure from competing savings institutions to level the playing field. I think that would be the only pressure on this committee.

I think the revenue loss is already built into these huge amounts of cash value that are out there and nobody is talking about that. So I think you are quite right in saying that it is this rapid build up and the way it is marketed that has called attention to this particular type of contract.

Chairman **Rangel**. Who is seeking recognition? Mrs. Kennelly.

Mrs. **Kennelly**. I just want to be clear on this, just a little follow up, Mr. Stark, on the chairman's question. We talk about the concern with single premium and we have these papers showing examples. Obviously, you are concerned about that, but as I read your bill, I see concern about borrowing from insurance policies. This goes all through the Stark-Gradison bill, you are concerned people are allowed to borrow from insurance policies and that they have some special advantage.

Is that concern more than your concern about single premium, is it on a par or would you be satisfied if we just cut single premium?

Mr. **Stark**. Well, there has always been, Barbara, a concern about borrowing out of cash value, the 4 and 7 rules that have been in effect a long time before the 1984 act.

Perceived abuses when interest was deductible, they were greater in routine and regular borrowing. It is the borrowing mechanism that allows single premium to become an investment mutual fund almost and so regular "borrowing" is a way you can have a tax free stream of income.

You could take a 20-paid policy and just, you know, cancel it at the end of the first year and if the forfeiture values were high enough, you could get the same results. So you can buy a 20-day product for 20 times as much as a single premium and cancel it and get the same effect.

You can package these things—to just say single premium, I think is begging the issue, much of the issue is contracts that are largely investment pools with very little insurance to them, and they have to go to the point where you can buy an insurance contract and have a checking account to write checks against your cash value, swap from one mutual fund to the other, and the next step will be any stock investment account that you want to have at Paine Webber, put a little insurance on the top and you can accumulate those dividends and buy and sell your stocks and that is not very far away from some of these contracts.

These are the kinds of things we are trying to control, if you will, and keep from growing into a gimmick to shelter otherwise taxable investment income, and really ruin this baby that Mr. McGrath doesn't want us to throw out with the bath water.

That is very tough because it is done under the same rules which originally allow this modest amount of inside build up to keep the premium level. That is always—that is why we gave it tax exemption in the first place, and as we have closed off other ways to accumulate tax-free income, this has become more and more popular, even though it has been perhaps the least efficient way because of its higher cost to buy it.

Chairman RANGEL. Anyone else seeking recognition?

Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Mr. Stark, in your last statement you may, in fact, be answering my question. I am wondering what is the acceptable ratio of investment to insurance that you consider acceptable and appropriate under policies. Would you elaborate on that? I think that is an important point. It seems that the magnitude of the relationship of the investment portion versus total premium.

Mr. STARK. Mr. Flippo, if you look at this whole life E–95 Universal policy, and I think yours will be colored yellow, that is the inside build up and the next line up is total cash value.

I can answer your question and this is really how we decided, as you recall in the 1984 act which you were part of writing, we said, how do you determine when enough is enough. How much inside build up should we allow, and we were convinced that there was no real economic reason for allowing inside build up. There was a traditional reason.

It had been around for a hundred years and it was going to be hard politically to knock it out or separate it without destroying the traditional product, so let's allow it. The amount that ought to be allowed, we felt, was that amount of cash value that was necessary to keep the premium level from the time of purchase until the time of mortality, your expected death date on $1,000 worth of whole-life insurance.

And further, at some—I have always thought at the income rate at which the life insurance company was willing to guarantee. That would mean that inside build up at a 4-percent guarantee contract setting, which many of these new single premiums are, would allow very much less inside build up. A lot of the other inside build up is the earnings which happened to be higher now than the historic earnings. May earn 8, 10, 12 percent. We said the amount you would earn at whatever the company is willing to guarantee for 20 or 30 years, however long this period is, ought to be all you are allowed to shelter.

The other earnings are really investment earnings. There is the company's willingness to speculate but it has never been guaranteed. So you could draw a chart. It would be different, and the GAO will suggest that as a way to control this for each age, for each premium dollar amount they could draw a separate little corridor or chart of how much cash value seemed reasonable.

But it was that amount that was necessary to level out the premium, assuming that one would pay premiums from the day they purchased the contract until the day they died, which is the traditional whole-life contract, and that is very much less cash value than in many of the contracts sold today.

Mr. **Flippo**. One of the reasons, then, that you are looking very carefully at the single premium is, in your view, the single premium probably has the largest increment of investment.

Mr. **Stark**. Absolutely. And a lot of it, answering Mr. Brown's concern, if it is a great new source of savings, then our problem is worse, but Mr. Brown would be happier because we have those savings. If it is as I suspect a transfer, most of the people take presently invested savings and putting them into single premium, we are still losing revenue if it didn't come from municipal bonds, but it may not grow as rapidly as it has in the years and the problem will kind of level out and perhaps go away.

I don't know that answer.

Mr. **Flippo**. Thank you for your response. I believe the chairman's point was that your concern is broader than the single premium and that it is looking at the entire investment——

Mr. **Stark**. Indeed it is.

Mr. **Flippo**. Thank you, Mr. Chairman.

Chairman **Rangel**. Mr. Gregg.

Mr. **Gregg**. I was wondering, Pete, if you could tell us of any other tax activity which you think falls into the description of insurance relative to this sort of treatment. Is there anything else that you have the same concern about?

Mr. **Stark**. I don't know of any I can think of now. I mean, unless you want to talk about stepped up basis at death and other things that we might do to close or to broaden the base in the tax policy.

I don't know of anything that has been so popularly sold in recent—in the past couple of years, since the 1986 act. I suspect that has a lot to do with the success of single premium. It was the only game in town. And it was promoted by a lot of sales people who saw it as a gimmick and it has been there. Actually, it could have been sold in the past. But I haven't seen any new hojoba bean scams on the horizon or the windmills seemed to have quieted down, so I can't think of anything now that has such significant aggregate dollars, that we ought to keep an eye on it.

Mr. **Gregg**. Well, does the investment in assets where we allow depreciation that is faster than the life of the asset fall into this essentially same category?

Mr. **Stark**. I am not so sure that is a problem unless you allow people to use that against other earned income. I mean the passive investment laws have tightened up a good bit on that. It would seem to me that we ought to assess every tax subsidy, based on what benefits we get from it.

And in the insurance industry, the best benefit I think we can get was touched on by Mr. Brown, and that is, there is not many places left in this world that could be a source of long-term fixed rate investment. But actually locking in the cash values, not encouraging people to take it out periodically, would help that, rather than hurt it.

But that is the last place that I know of with savings banks and everybody else paying variable rates, it is very hard to find a source of major investment capital that somebody would commit five years at a fixed rate for, for example. And so from the economic standpoint, we probably ought to encourage locking up cash values to the extent that that has an economic benefit.

Mr. GREGG. At the same time we do that, should we reinstitute the IRA accounts as a way to generate long-term capital?

Mr. STARK. I never thought that IRA accounts did anything except for very rich people who would save anyway. I think the statistics prove that. So that if you want to find ways to encourage wealthy people to save more without paying taxes, there is a host of ways. IRA's, Keough's, and single premium. But I don't know that that is what we ought to be doing with the tax code.

Chairman RANGEL. Mr. McGrath.

Mr. MCGRATH. Thank you.

Pete, is it fair to say that without single premium policies it would be a lot more difficult for you to make your argument regarding the loan and tax properties of other life insurance products, vis a vis, other investment products than what you have today?

Mr. STARK. Absolutely. In other words, I think that there is lower, there is a perception of something that is too good. You are going to hear from the industry today. It is a hellishly good product. I can show you all examples, if we weren't trying to take away the tax exemption and very seldom would I urge any of you to spend any money on life insurance.

This isn't a bad product considering what is out there today. The question is how much are you willing to subsidize it. It does not necessarily go to other products. One of the reasons is the commission rates are about 2 percent as opposed to 120, 130, 140 percent for most other kinds of life insurance. So right out of the box you are saving a lot of money for the acquisition cost.

Mr. MCGRATH. We understand the consternation among those within the industry regarding this product. Let me ask you specifically, about the retroactive application of any changes. Do you favor retroactive changes?

Mr. STARK. That existing money in current contracts should be left as it is under present rules. Normally you would say new contracts, the problem is some of these contracts are so open ended that you could take those contracts and add money to them forever. So basically, money that is in gets present treatment. New money that is paid in in the form of premiums, not necessarily mutual dividends, if there are any, would get new treatment, if in fact we do treat it so that similar to what we did with annuities in 1982, when, we made the same change in the annuity rule.

Mr. MCGRATH. One last question. Where do you think we are going to end up on this?

Mr. STARK. I think there are only three ways to control. One is to increase taxes on life insurance companies which is cumbersome and there is a way to get some of this money back, to deal with the definition which people talked about and some groups of the industry would prefer. It is somewhat more complex and it still could be gamed by creative systems people.

The third way is to limit similar to the way we limited other pensions. The only reason I tend to like that best is it is uniform in its application to the other types of investment products. We could put an aggregate limit on it, but I am afraid that that would be—the industry would halt that because that would put a limit on what they could sell.

I don't think that is very good. I don't know as there are any other approaches, and you could take a combination of tightening definition and some penalty, or you can do it all with definition or all with distribution rules and penalties we have, and you will get as many recommendations on that as you will get witnesses.

Mrs. KENNELLY. Would the gentleman yield?

Ray started to get onto something I would like, Mr. Chairman, to clarify and I will be very quick. Mr. Stark just mentioned distribution requirements for annuities that we approved in 1986. Those were grandfathered, as you said. We grandfathered what we did in 1982. Then in your testimony a little earlier, you said, well, don't be concerned about grandfathering, but yet as I read your bill, there is a restriction on loans taken after 1987.

Mr. STARK. Introduction.

Mrs. KENNELLY. It is a 1987 date. Aren't you being harsher in your bill on loans from the contractors than we have ever been in the past?

Mr. STARK. We, I think we took the same grandfathering we did from annuities, exactly. That may work out differently on these, but I notice staff behind you nodding their agreement that it was our intention to, in a sense, grandfather all investments that are in these products, and the only reason we don't speak specifically to contracts, that you understand, you can take a contract and triple the size of it and you wouldn't cut out growth.

Mrs. KENNELLY. See, that is my concern. You grandfathered loans, but only if they exist on October 7. I found the date, October 7, 1987, without regard to when the contract was made. So that is harsher.

Mr. STARK. No; honestly, I don't think so. In other words, if you have a contract that is paid for, and you purchased it prior to whatever the enactment, you can do whatever you want, you operate under the old realm.

Mrs. KENNELLY. It wouldn't be penalized?

Mr. STARK. Wouldn't be penalized. Now, if you take that contract, let's say you paid $10,000 for it and a couple years from now, try and put another $100,000 in it, that is what you can't do. You would have to go buy a new contract. That is all we are saying. Or have the contract separable.

Mrs. KENNELLY. You can't take a loan on that contract, original contract, without being penalized?

Mr. STARK. Beg pardon?

Mrs. KENNELLY. You can't take a loan on the original contract without being penalized?

Mr. STARK. All we have said is if you add to a contract, you have to do it as if it were a new contract or a new part. I mean that is the only real difference.

Chairman RANGEL. Let me make it clear to the committee and those interested, if we did not have the Stark-Gradison bill, we still would be having these hearings, and we are glad our colleague has introduced this legislation based on his expertise, but it is merely a focal point for us to deal with a real problem that exists here.

I wanted to thank the gentleman for his contribution and to point out that his entire written statement will be included in the record.

We will now hear from the Treasury, Dennis Ross, Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury. Your statement will be entered into the record. You can proceed as you find convenient.

Thank you, Mr. Ross.

STATEMENT OF DENNIS E. ROSS, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. Ross. Thank you, Mr. Chairman. I am pleased to have the opportunity to present the views of the Treasury Department on the treatment of life insurance contracts purchased principally for investment purposes. The taxation of life insurance contracts is, of course, a difficult and controversial subject and there may be an understandable reluctance to give renewed attention to basic issues previously considered very recently.

We share that reluctance. During the development of both the Deficit Reduction Act of 1984 and the 1986 Tax Reform Act, the decision was made to retain a central feature of the taxation of life insurance contracts. That is, a deferral of tax on the inside build up of such contracts. We do not believe that this basic issue should be reconsidered at this time. The deferral of tax on inside build up on life insurance and also on deferred annuity contracts is, however, recognized as a tax expenditure, estimated in the President's fiscal year 1989 budget at approximately $5.4 billion per year.

Given the substantial revenue costs involved, we believe it is appropriate to examine whether the policies supporting favorable tax treatment of life insurance contracts are being adequately served at this time. In particular, the recent growth in the sales of heavily investment oriented policies, including single premium policies, raises the question of whether current law permits the use of the preference intended for life insurance in situations not truly intended by Congress.

My testimony today will discuss first the basic structure of and the tax rules applicable to life insurance contracts. I will next briefly describe various proposals that have recently been made to revise the tax rules applicable to life insurance and finally I will discuss the Treasury Department's views on these proposals.

Just as background, analyzing the investment uses of life insurance contracts requires a basic understanding of how life insurance contracts are structured. The simplest form of life insurance is, of course, term insurance. The premium on a term insurance policy goes to pay two separate charges—so-called loading charges which cover the insurance company's operating expenses and its anticipated profit, and mortality charges, the amount actually paid for the insurance protection.

Since the entire premium on a term policy is used to pay loading and mortality charges, no excess value accumulates. In contrast to this feature of term insurance, cash value life insurance has an investment component similar in concept to a savings account. The investment component arises from the fact that during one or more of the early years of the policy, the policyholder pays a higher premium than is necessary to cover the loading charge and the current mortality charge.

The excess premiums accumulate in a fund held by the insurance company for the benefit of the policyholder. That accumulated investment fund may be withdrawn by the policyholder through a loan or cash distribution. It is referred to as the cash value of the contract. Several consequences follow from the existence of a cash value in a life insurance policy.

First, the insurance company bears the insurance risk only to the extent the death benefit under the policy exceeds the cash value of the policy, since any payment of death benefits represents, in part, a return to the policyholder of the policy's cash value.

Second, the cash value on a policy earns an investment return. That investment return is used to pay mortality charges and any annual loading charge, with any remaining amount increasing the policy's cash value.

Third, the investment earnings under the policy, together with any additional premiums paid on the contract, exceed the annual mortality loading charge, thereby increasing over time the policy's cash value. Each year that cash value increases, the amount of the company's insurance risk correspondingly decreases. When the policy matures, typically at age 95, the cash value of the contract will equal the policy's death benefit.

These three features—the reduction of the insurance risk by the accumulating cash value, the earning of investment income on the cash value, and the resulting growth of the cash value toward the amount of the policy's death benefit—are typical of all cash value life insurance policies.

Although all cash value policies have an investment component, the relative significance of that component is affected by the period of time over which the policyholder pays premiums on the policy. Level premium contracts require the payment of annual level premiums over the lifetime of the policyholder.

In contrast, limited premium contracts require the payment of larger premiums over a shorter period, the most extreme example being a single-premium contract.

Although the cash value of both level premium and limited premium contracts will grow eventually to equal the death benefit at the maturity of the policy, the growth is due, in part, to the payment of additional premiums in the case of a level premium policy, but in the case of a single-premium policy, that growth is due entirely to the earning of investment income.

One simple measure of the investment orientation of a contract is the relationship of cash value of the contract to the amount of the policy's death benefit. At all times, a limited premium contract would have a higher cash value in relation to the death benefit than will a level premium contract.

Accordingly, the fewer payments that are made under the contract to fund a given level of a death benefit, at a given age, the greater the investment orientation of the contract.

Cash value life insurance may also be divided between nonvariable and variable contracts and between traditional and universal life contracts.

Briefly, with a nonvariable contract, the insurance company guarantees that the investment return each year on the cash value of the contract will not be less than a specified rate. In the case of variable contracts, the cash value is invested in a portfolio of assets segregated from the general investment accounts of the insurance company, with the policyholder's return depending upon the investment experience of that segregated account.

The policyholder is typically able to choose among several different segregated accounts, having several different characteristics. For example, accounts invested in money market instruments, long-term debt instruments or equity stocks.

The distinction between traditional and universal life contracts turns on whether the premium payments and death benefit under the contract are predetermined. They are in the case of traditional policies; but subject to certain restrictions, the premium payments and the death benefit may be varied by a policyholder over the life of the policy in the case of a universal contract.

The recent trends in the life insurance industry including particularly the development of variable and universal life insurance contracts, have made life insurance a more attractive investment vehicle for consumers than in the past.

These developments together with the fact that life insurance companies are generally setting investment returns in direct competition with all the alternative investments make it additionally appropriate that the tax treatment of investment oriented policies be reexamined.

Let me turn now to the taxation of life insurance contracts under current law. I will try to be brief.

As you know, the Federal income tax rules applicable to life insurance are favorable in a number of respects. First, as I indicated earlier, the inside build up on life insurance contracts is not currently taxed. In addition, if the contract is held until death all of the benefits are excluded from the income of the beneficiary of the policy. Thus, to the extent the death benefits are attributable to inside build up, investment income earned on the contract is not simply deferred, but permanently exempted from tax.

Second, loans against life insurance contracts are generally respected as such and not treated as potentially taxable distributions.

Third, distributions with respect to life insurance contracts are included in the policyholder's income only to the extent that those distributions exceed the premiums previously paid by the policyholder. That is, the policyholder is permitted to recover the full amount of his prior payments before any investment income on the policy is taxed.

These favorable rules apply only to contracts that meet the definition of a life insurance contract stated in section 7702 of the current law. This section was adopted in the 1984 act and was intended to prevent contracts that provide for much larger investments or build up of cash value than traditional products from qualifying for favorable life insurance tax treatment. The investment income, of course, where the contract does not qualify under this test is taxed currently. In order to qualify as life insurance under section 7702, the contract must be a life insurance contract under the applicable, typically State law, and must satisfy either a cash value accumulation test or a guideline premium and cash value corridor test. These tests limit either the permissible amount of the cash value of the policy or the premiums paid in and the cash value of the policy in relation to the death benefit provided under the policy. The tests thereby restrict the investment orientation of a life insurance contract since, as I indicated earlier, the degree of investment orientation of a contract is principally a function of the relationship between the contract's cash value and its death benefit.

The tax rules applicable to life insurance contracts may usefully be contrasted with the rules applicable to deferred annuity contracts and individual retirement accounts, two other forms of tax favored investment available to individuals.

The inside buildup on deferred annuity contracts owned by individuals, like that on life insurance contracts, is not taxed currently. In other respects, however, the tax treatment of deferred annuities is significantly less favorable than the tax treatment of life insurance.

Inside buildup on deferred annuity contracts is taxed to the ultimate recipient of payment, under the annuity. Loans with respect to deferred annuities are treated as taxable distributions.

An annuity owner is not permitted to recover his investment in the annuity before being taxed on distribution.

Taxable distributions made before the annuity owner attains age 59½, dies, or becomes disabled generally are subject to a 10-percent premature distribution penalty. The taxation of IRAs is similar in many respects to the taxation of deferred annuities.

Investment income earned on IRAs is not taxed currently. The income, however, does not escape taxation entirely even if the IRA is held until death but is taxed to the ultimate recipient of the funds. Loans with respect to an IRA result in disqualification of the IRA and are deemed a taxable distribution to the individual to the extent of the amount invested in the IRA. IRA distributions are treated as pro rata recoveries of investment and taxable income and premature distributions are subject to a similar 10-percent penalty tax.

Since the passage of the Tax Reform Act, a number of proposals have been made to revise the current tax rules applicable to life insurance.

These proposals are driven, in part, by a perception that life insurance contracts have become increasingly investment oriented. Certainly that perception has been encouraged by the promotional materials referred to previously that have been prepared by some sellers of single-premium contracts. They emphasize the ability of the policyholder to earn and withdraw investment income without payment of tax, and refer to insurance protection merely as an incidental attribute necessary only to obtain favorable tax treatment.

Beyond the question of perception, however, there is empirical evidence that the use of life insurance contracts for investment proposes has significantly increased since 1984, as illustrated in the table attached to my testimony. Between 1984 and 1987, annual sales of single-premium policies grew from $1 to $9.5 billion.

During that same period, single-premium sales grew as a percentage of the total first year premiums on all ordinary life policies from 10.8 to 48.5 percent, nearly half of all first year premiums.

Three basic types of proposals have been made for revising the taxation of life insurance with respect to investment oriented policies. The first would exclude certain investment oriented contracts from the definition of life insurance for Federal tax purposes. As a consequence, inside buildup on these policies would be subject to current taxation.

The second type of proposal would leave the current statutory definition of life insurance unchanged and thus not affect the treatment of inside buildup but would revise the rules for taxing loans and distributions with respect to some or perhaps all life insurance contracts.

For example, H.R. 3441, introduced by Representatives Stark and Gradison, would conform the life insurance loan and distribution rules to those applicable to deferred annuity contracts. Thus, as Mr. Stark discussed previously, loans would be treated as actual distributions, distributions would be taxable to the extent of untaxed inside buildup, and premature distributions would be subject to an additional 10-percent tax.

H.R. 3441 would apply these rules to all life insurance contracts and not simply single-premium or excessively investment oriented contracts.

The third set of proposals recently discussed would revise the rules applicable to life insurance contracts to the extent held by certain persons. For example, proposals have been made to exclude from the statutory definition of a life insurance contract policies owned by corporations and other nonnatural persons. Again, inside buildup on such contacts as a consequence of that change would not be subject to current taxation.

Before discussing these possible legislative proposals or changes in detail, it is appropriate to consider the rationale for the current tax treatment of life insurance contracts. Some in the life insurance industry have suggested that inside buildup on a life insurance contract is no different than unrealized appreciation on other assets, such as a share of stock or a parcel of real estate and, thus, that no tax should in any event be imposed until the policyholder disposes of the life insurance contract. We believe this analysis is misconceived and that inside buildup is directly analogous to forms of income that are currently taxed, such as interest from a savings account, or the return on a mutual fund investment.

But independent of this question of normative tax accounting, there are legitimate policy arguments for the current tax treatment of life insurance. The insurance industry has argued that such tax favored treatment encourages purchase and maintenance of life insurance protection, encourages long-term savings, protects policyholders from being subject to tax before they have received cash with which to pay the tax, and finally, avoids complexity and policyholder confusion that could result from attempting to impose a tax.

The first of those justifications, that of encouraging life insurance protection, would seem the most compelling rationale since there are substantial social benefits in life insurance protection. In the event of a death of a working spouse, life insurance proceeds can be a source of support to the surviving spouse and minor children and enable those survivors to maintain their standard of living. In certain cases, life insurance may enable the surviving spouse and minor children to avoid becoming dependent on governmental assistance, thereby by relieving the government of that obligation.

With that rationale in mind, let me turn to the specific proposals to change the tax treatment of life insurance and again especially investment oriented life insurance. Let me begin first with the proposals to revise the definition of life insurance.

The changes made in the 1984 act to restrict investment oriented contracts have not prevented contracts with a substantial investment component—here again I include single-premium contracts—from retaining tax favored treatment. The actuarial test of section 7702 permits use of very conservative interest rate assumptions and does not limit assumed mortality charges. They thus have the effect of increasing initial cash value and reducing the amount of insurance risk. As a consequence, we believe one reasonable approach to further restricting investment orientation of life insurance contracts would be to require more realistic actuarial assumptions than the current statutory definition of life insurance.

A second approach, again amending the definition, would be to prevent or exclude from section 7702 single-premium and other contracts that are funded more rapidly than over a specified period of time. Now while that approach, I believe, is defensible in concept, it is arguably an overreaction to the problem we face.

Single premium contracts may have significant nontax advantage such as a more efficient marketing and distribution system. Excluding such contracts categorically from the definition of insurance would likely prevent consumers from receiving those benefits.

In addition, it would be somewhat incongruous to tax inside buildup on single-premium policies—again that is a consequence of treating them not as an insurance—while continuing to permit deferral of tax on the inside buildup of annuity contracts which everybody concedes are pure savings vehicles.

Turning to proposals that would revise treatment of loans and distributions on life insurance policies, it is arguable that changes in this area are fully consistent with the policies that support tax favored treatment of life insurance. The withdrawal of cash from the life insurance contract, whether it is for a loan or for actual distribution, reduces the net death benefit payable under the contract by the amount of withdrawal, it reduces the long-term savings under the contract, again, by the amount of the withdrawal, and it makes available to the policyholder sufficient funds to pay any tax liability that might be triggered by that distribution.

The current loan and distribution rules applicable to life insurance contracts do not provide any disincentive to the withdrawal of cash from life insurance contracts. A failure in this regard to discourage cash withdrawals is in stark contrast to the treatment of deferred annuity contracts and IRA's, where all distributions are taxed in whole or in part and loans are treated as taxable distributions or simply prohibited.

At least with respect to investment oriented life insurance contracts, we see no valid tax policy reason for the absence of similar restrictions on life insurance contracts. Since all cash value policies have a significant investment element, it is arguable that revised distribution rules should apply to all cash value policies as proposed in the Stark-Gradison legislation.

As I discussed earlier, however, the investment orientation of single-premium and other limited premium contracts is substantially greater than the investment orientation of level premium policies. The justification for imposing distribution rules similar to those that applied to deferred annuities—that is, in order to recapture the tax preference for the preferred investment that has not been used for insurance purposes—is significantly stronger in the case of limited premium contracts than in the case of level premium contracts.

For this reason, it may well be appropriate to limit distribution restrictions to limited premium contracts.

Let me turn finally to life insurance contracts owned by businesses or non-natural persons. Such contracts raise two particular tax policy concerns.

First, subject to a $50,000 per insured limit imposed by current section 264 of the code, interest on policy loans is generally deductible by the business policyholder. The allowance of a deduction for the interest, while the corresponding inside buildup escapes current taxation, serves simply to shelter other income from tax.

The purchase by businesses of life insurance contracts for the principal purpose of obtaining this tax shelter was common prior to the Tax Reform Act and continues to occur under current law. The only change in practice is that in order to stay below the $50,000 ceiling set in section 264, businesses trying to utilize this tax shelter are forced to purchase smaller policies on a larger number of employees.

The second subject of concern in this area is the use of life insurance contracts by businesses to fund deferred compensation, health benefits, and other future liabilities unrelated to death benefits. The ability to use tax-free inside buildup to fund deferred compensation may act as a disincentive to provide benefits through qualified plans, which as you know are subject to nondiscrimination rules and other restrictions.

With respect to the funding of health benefits and similar future liabilities, Congress has specifically decided not to permit the funding of such liabilities on a tax favored basis. Thus the use of life insurance to fund such benefits is inconsistent with that stated policy.

Accordingly, we believe that the use of life insurance contracts by businesses for purposes other than the funding of death benefits is an area that may warrant examination by Congress and this subcommittee; in particular, it may be appropriate to examine whether the limits imposed by the tax reform act on the deduction of interest on life insurance policy loans are, in fact, ⅛serving their intended purpose.

Mr. Chairman, that concludes my prepared remarks. I would be pleased to respond to any of your questions.

[The statement of Mr. Ross follows:]

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STATEMENT OF
DENNIS E. ROSS
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to present the views of the Treasury Department on the issue of whether the current tax treatment of life insurance contracts that are purchased principally for investment purposes is appropriate.

The taxation of life insurance contracts is a difficult and controversial subject. Accordingly, there may be understandable reluctance to give renewed attention to basic issues previously considered in recent years. We share that reluctance. During the development of both the Deficit Reduction Act of 1984 (the "1984 Act") and the Tax Reform Act of 1986 (the "Tax Reform Act") the decision was made to retain a central feature of life insurance contract taxation -- deferral of tax on the "inside build-up" on such contracts. We do not believe that this basic issue should be reconsidered at this time.

The deferral of tax on inside build-up on life insurance and deferred annuity contracts is recognized as a tax expenditure, estimated in the President's fiscal year 1989 budget at approximately $5.4 billion per year. Given the substantial revenue costs involved, we believe it is appropriate to examine whether the policy goals that have been relied upon by Congress in continuing favorable treatment of life insurance contracts are being met at this time. In particular, the recent growth in the sales of heavily investment oriented life insurance contracts, including single premium contracts, raises the question whether current law permits use of the preference in situations not intended by Congress.

My testimony today will first discuss the basic structure of, and the tax rules applicable to, life insurance contracts. Second, I will briefly describe various proposals that have been made following enactment of the Tax Reform Act to revise the tax rules applicable to life insurance contracts. Finally, I will discuss the Treasury Department's views regarding these proposals.

I. Background

A. Structure of Life Insurance Contracts

Before one can understand the investment uses of life insurance contracts, one must understand how life insurance contracts are structured. This can best be done by first examining a life insurance contract that lacks a significant investment element, such as a one-year term insurance contract. The premium under such a policy represents two separate charges -- a "loading" charge, which covers the insurance company's operating expenses and anticipated profit, and a mortality charge, which covers the company's obligation to pay the specified death benefit in the event the policyholder dies during the term of the policy. The mortality charge is determined by multiplying the amount of insurance coverage by the estimated probability of death during the term of the policy. This probability generally is based on published mortality tables.[1]

For example, consider a one-year term life insurance policy with a death benefit of $100,000 purchased by a 55-year old individual. A standard mortality table indicates that the probability that a 55-year old policyholder will die during the following year is 1.05 percent. If this table is used in pricing the policy, the mortality charge for the $100,000 policy would be $1,050. The total premium would be $1,050 plus the loading charge. If a new one-year policy is purchased in the following year, the mortality charge would be $1,150, reflecting the increased probability (to 1.15 percent) of mortality due to the increased age of the policyholder.

In the one-year term policy described above, the entire premium is used to pay loading and mortality charges. No excess value remains at the end of the one-year term. A cash value life insurance policy differs from a term policy in that it has an investment component equivalent to a savings account. The investment component arises from the fact that, during one or more of the early years of the policy, the policyholder pays a higher premium than is necessary to cover the loading charge and the current mortality charge. For example, the policyholder in the above example, rather than purchasing annual term insurance, might pay a single premium of approximately $35,000, plus loading charges, for permanent insurance coverage. The excess premiums accumulate in a fund held by the insurance company for the benefit of the policyholder. This accumulated investment fund typically may be withdrawn by the policyholder through a loan or cash distribution, and is referred to as the "cash value" of the contract.

Several consequences follow from the existence of a cash value. First, the insurance company bears an insurance risk only to the extent the death benefit exceeds the cash value of the contract, since any payment of death benefits represents, in part, a return to the policyholder of the cash value. In the example, the mortality charge for the first year the policy is in effect will be $688 (1.05 percent times $65,665) rather than $1,050.

Second, the cash value will earn an investment return. The investment earnings in the example, assuming a 6 percent return, would be $2,060. These investment earnings are used to pay the mortality charge and any annual loading charges, with any remaining amount increasing the cash value. If earnings are greater than 6 percent, the cash value of the contract will either grow more quickly or cash will be distributed to the policyholder.

Third, the investment earnings under the policy (together with any additional premiums paid under the contract) exceed the annual mortality and loading charges, thereby increasing the cash value. In the example, the cash value increases during the first year from $35,022 to $36,395. Thus, in the second year of the policy, the amount of the insurance risk is reduced from $65,665 to $64,343, the mortality charge is $737 (1.15 percent times $64,343), and the investment earnings are $2,139. Each year, the cash value increases and the amount of the insurance risk decreases. When the policy "matures," typically at age 95, the cash value of the contract will equal the death benefit. Table 1 illustrates the pattern of cash values, investment earnings, and mortality charges for the entire term of the contract in the example.

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[1] If the mortality charge is based on a conservative mortality table that overstates the probability of death, anticipated profit may also be built into the mortality charge.

These three features -- the reduction of the insurance risk by the cash value, the earning of investment income on the cash value, and the resulting growth of the cash value toward the amount of the death benefit -- are typical of all cash value life insurance contracts. While sharing these features, different cash value life insurance contracts may vary in several other respects. Since some of these variations affect the degree to which contracts may be used as investment vehicles, it is useful to discuss these variations.

The distinguishing factor that most directly affects the nature of a contract as an investment or insurance vehicle is the period over which the policyholder pays premiums under the contract. Level premium contracts require the payment of level annual premiums over the entire lifetime of the policyholder. In contrast, limited premium contracts require the payment of larger premiums over a shorter period. The most extreme example of a limited premium contract is a single premium contract. Although the cash value of both level premium and limited premium contracts will grow to equal the death benefit at the maturity of the policy, the growth is due in part to the payment of additional premiums in the case of a level premium policy but is due entirely to the earning of investment income in the case of a single premium contract.

It is not possible to measure precisely at the time of purchase the investment orientation of an insurance contract since policyholders are commonly credited with more than the guaranteed investment return on the cash value, and are charged less than the stated mortality charges, through the crediting of excess interest and the payment of policyholder dividends. One simple measure, however, of the investment orientation of a contract is the relationship of the cash value of the contract to the amount of death benefits. At all times, a limited premium contract will have a higher cash value in relation to the death benefits than will a level premium contract. Accordingly, the fewer payments that are made under a contract to fund a given level of death benefits at a given age, the greater the investment orientation of the contract. The premiums (net of loading charges), cash value, investment income, and mortality charges for a level premium policy providing death benefits of $100,000 for a 55-year old policyholder are illustrated in Table 2. A comparison with Table 1 demonstrates the consistently higher cash values and investment earnings and the consistently lower mortality charges.

A second major distinction that can be drawn among cash value life insurance contracts is between non-variable and variable contracts. In the case of a non-variable contract, the insurance company guarantees that the investment return each year on the cash value of the contract will not be less than a specified rate. The insurance company may at its discretion credit a higher rate of return on the cash value if, for example, the company's return on its investments substantially exceeds the guaranteed rate. In the case of a variable contract, the cash value is invested in a portfolio of assets segregated from the general investment accounts of the insurance company. The cash value may increase or decrease depending on the investment experience of the segregated account. The policyholder is typically able to choose among several different segregated accounts having different general investment strategies, *e.g.*, accounts invested in money market instruments, long-term debt instruments, or stocks. Thus, a policyholder owning a variable contract can exercise general control over the investment of his funds while they are held by the insurance company.

A third major distinction that can be drawn among cash value life insurance contracts is between traditional and universal life contracts. In the case of a traditional contract, the premium payments, cash value, and death benefits under the contract bear a predetermined relationship. Mortality and loading charges and the rate of investment return on the cash value are assumed in setting the premiums for the policy, but the charges and investment return may not be separately stated. In the case of a universal life policy, the different elements of the life insurance contract are "unbundled." Subject to some restrictions, the policyholder may vary the schedule of premium payments and the level of death benefits. Universal life contracts are not, by nature, more or less investment oriented than traditional contracts. In both cases, the degree of investment orientation principally depends on the relationship between cash value and death benefits.

Recent trends in the life insurance industry have made life insurance a more attractive investment vehicle for consumers than in the past. First, life insurance companies are generally crediting higher investment returns in direct competition with alternative investments. Second, with the development of variable contracts, life insurance companies are offering investors choices of alternative investments within a life insurance contract. This provides policyholders with more choices of investment strategy, and shifts some of the investment risks, and potential returns, to policyholders. Finally, life insurance companies offer more choices in the setting of the level and timing of premium payments and the level of death benefits.

B. Taxation of Life Insurance Contracts

The Federal income tax rules applicable to life insurance contracts are favorable in a number of respects. First, as indicated earlier, the inside build-up on life insurance contracts is not taxed currently. In addition to allowing a deferral of tax during the policyholder's life, if a contract is held until death, all of the benefits are excluded from the income of the beneficiary. Thus, to the extent the death benefits are attributable to inside build-up, investment income earned on the contract is permanently exempted from tax.

Second, loans against life insurance contracts are generally respected as such and are not treated as potentially taxable distributions. This treatment is allowed notwithstanding that such loans may not be treated as indebtedness for state law purposes, the policyholder may be under no obligation to repay the loan before death, and the interest on the loan may be tied to the investment return credited on the cash value of the contract. Moreover, interest on the loans may be deductible even though the inside build-up on the contract is not currently taxable. Section 264 of the Internal Revenue Code (the "Code") contains interest deduction limitations that were intended to prevent the purchase of life insurance policies solely to utilize policy loans to produce a tax shelter, but these limitations are easily avoided. Most recently, the Tax Reform Act amended section 264 to prevent businesses from deducting interest on policy loans to the extent the aggregate amount of loans with respect to any one individual exceeds $50,000. There is, however, no limit on the number of insured individuals with respect to whom separate $50,000 loans are permitted.

Third, distributions with respect to life insurance contracts are included in the policyholder's income only to the extent that the distributions exceed the premiums paid by the policyholder. Thus, the policyholder is permitted to recover the full amount of his premium payments before any income is taxed. Moreover, because the cash value of a life insurance contract is reduced by the mortality charges under the contract, such mortality charges are, in effect, deducted against investment income. This treatment is much more generous than the treatment of a separate purchase of insurance protection since the cost of insurance protection is a personal expense and not deductible.

These favorable rules apply only to contracts that meet the definition of a life insurance contract contained in section 7702 of the Code. Section 7702 was adopted in the 1984 Act to prevent contracts "that provide for much larger investments or buildups of cash value than traditional products" from qualifying for the favorable life insurance tax rules.[2] The investment income with respect to a nonqualifying contract (unreduced by mortality charges) is taxed currently.

In order to qualify as life insurance under section 7702, a contract must be a life insurance contract under the applicable law and must satisfy either the "cash value accumulation" test or the "guideline premium/cash value corridor" test. These tests limit either the permissible amount of the cash value (in the case of the cash value accumulation test) or the premiums paid and the cash value (in the case of the guideline premium/cash value corridor test) of a contract in relation to the death benefits provided under the contract. The tests thereby restrict the investment orientation of life insurance contracts since, as discussed earlier, the degree of investment orientation of a contract is principally a function of the relationship between the contract's cash value and death benefits.

C. Taxation of Deferred Annuities and IRAs

The tax rules applicable to life insurance contracts may be contrasted with those applying to deferred annuity contracts and individual retirement accounts, two other forms of tax favored investment available to individuals.

The inside build-up on deferred annuity contracts owned by individuals, like that on life insurance contracts, is not taxed currently. In other respects, however, the tax treatment of deferred annuity contracts is significantly less favorable than the treatment of life insurance contracts. First, the inside build-up on deferred annuity contracts held until death is not exempted from tax. Rather, the inside build-up is taxed to the ultimate recipient of payments under the annuity since no step-up in basis at death is allowed with respect to annuity contracts. Second, loans with respect to deferred annuity contracts owned by individuals are treated as non-annuity distributions potentially subject to tax. Third, a contract owner is not permitted to recover his investment before being taxed on distributions. Non-annuity distributions (e.g., loans or partial withdrawals) are included in taxable income to the extent of the inside build-up on the contract. That is, the contract owner's investment is recovered only after all investment income has been taxed. Annuity distributions are subject a pro rata income inclusion rule. Fourth, taxable distributions with respect to a deferred annuity made before the contract owner attains age 59-1/2, dies, or becomes disabled generally are subject to a 10 percent premature distribution penalty.

The taxation of IRAs is similar in many respects to the taxation of deferred annuity contracts. Investment income earned on IRAs is not taxed currently. The income does not, however, escape taxation entirely if the IRA is held until death, but is taxed to the ultimate recipient of the funds. Loans with respect to, or pledges of, an IRA result in disqualification of the IRA and a deemed taxable distribution to the individual of the amount invested in the IRA. IRA distributions are treated as pro rata recoveries of investment and taxable income. Taxable distributions with respect to an IRA made before the owner attains age 59-1/2, dies, or becomes disabled generally are subject to a 10 percent premature distribution penalty.

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[2] H.R. Rep. No. 98-432, 98th Cong. 1st Sess. 102 (1984).

The taxation of IRAs differs from that of insurance products in two important respects. First, IRA investments may be deducted in whole or in part by individuals who either have income of not more than $35,000 ($50,000 for married couples filing jointly) or are not active participants in an employer-maintained retirement plan. IRA investments by other individuals are not deductible. Second, a significant limitation is imposed on the amount that may be invested in an IRA -- annual IRA investments cannot exceed the lesser of $2,000 or 100 percent of earned income. This limitation applies whether or not the individual's investment in the IRA is deductible.

II. Proposals for Change

Since the enactment of the Tax Reform Act, a number of proposals have been made to revise the current tax rules applicable to life insurance contracts. These proposals reflect, in part, a perception that life insurance contracts have increasingly been purchased in order to obtain tax-sheltered investment income rather than to obtain life insurance protection. Promotional materials prepared by some sellers of single premium contracts that emphasize the ability to earn and withdraw investment income without payment of tax, and refer to insurance protection as merely an incidental attribute necessary to obtain the tax benefits, have drawn particular attention.

There is empirical evidence that the use of life insurance contracts for investment purposes has significantly increased since adoption of a statutory definition of life insurance in 1984. This increase has continued following the Tax Reform Act. Table 3 illustrates the growth in sales of single premium life insurance policies. Between 1984 and 1987, annual sales of single premium policies grew from $1.0 billion to $9.5 billion. As a percentage of total first year premium receipts on newly issued ordinary life policies, single premium sales grew during this period from 10.8 percent to 48.5 percent.

Proposals of three different types have been made for restricting the use of cash value life insurance policies while retaining the basic tax preference for inside build-up. The first set of proposals would exclude certain investment oriented contracts from the definition of a life insurance contract for Federal income tax purposes. Inside build-up on contracts not meeting the revised definition would be taxed currently. Such a proposal has been made by the National Association of Life Underwriters ("NALU"). In general, the NALU proposal would require that life insurance contracts be funded no more rapidly than ratably over a five-year period.

The second set of proposals would leave the current statutory definition of a life insurance contract (and the basic allowance of deferral of tax on inside build-up on such contracts) unchanged, but would revise the rules for taxing loans and distributions with respect to some or all life insurance contracts. For example, H.R. 3441, introduced by Reps. Stark and Gradison, would conform the life insurance loan and distribution rules to those applicable to deferred annuity contracts. Thus, loans would be treated as actual distributions, distributions would be taxable to the extent of untaxed inside build-up, and taxable distributions made prior to age 59-1/2, death, or other specified circumstances would be subject to an additional 10 percent income tax. H.R. 3441 would apply to all life insurance contracts.

The third set of proposals would revise the rules applicable to life insurance contracts held by certain persons. For example, proposals have been made to exclude from the statutory definition of a life insurance contract policies owned by corporations and other non-natural persons. Inside build-up on contracts not meeting the revised definition would be taxed currently.

III. Discussion

A. Rationale for Restrictions on Life Insurance

Before discussing in detail possible changes in the taxation of life insurance contracts, it is appropriate to examine why any restrictions are imposed on life insurance contracts. Some in the life insurance industry have suggested that the inside build-up on a life insurance contract is no different from the unrealized appreciation on other assets such as shares of stock or parcels of real estate and, therefore, that no tax should be imposed until the policyholder disposes of the life insurance contract. We do not believe that inside build-up on life insurance contracts is properly analogized to unrealized appreciation on stocks or real estate.

As described earlier, in the case of non-variable life insurance contracts, the insurance company is obligated to credit a guaranteed fixed rate of investment return on the cash value and may at its discretion credit additional amounts annually. It is difficult to distinguish the investment return on the cash value of such contracts from the investment return on a savings account or other interest-bearing obligation. The investment return on interest-bearing obligations (both fixed returns and, once fixed, contingent returns) generally is taxed as it is earned. While the taxation of interest income as it is earned has not been extended to market discount, the issuer of a debt instrument with market discount does not deduct the market discount. In the case of a life insurance contract, the life insurance company is allowed a deduction for the increase in the cash value of a life insurance contract.

In the case of variable life insurance contracts, the policyholder holds an indirect interest in the portfolio of assets held by the separate account. The policyholder's investment in the variable contract is analogous to an interest in a mutual fund or partnership. While mutual funds and partnerships are not subject to tax at the entity level, their owners are taxed currently on all of the ordinary income and capital gains realized by the entity. In contrast, under the variable contract rules, neither the insurance company nor the policyholder is taxed currently on the income and gains of the separate account. Similarly, owners of interests in mutual funds or partnerships recognize gain or loss when they sell or exchange such interests. In contrast, the owner of a variable contract may switch his investment among different portfolios underlying a separate account (e.g., liquidating his investment in a stock account and reinvesting in a money market account), thereby changing the nature of his investment, without recognizing taxable gain or loss.

For the reasons discussed above, we believe it is clear that the deferral of tax on inside build-up on life insurance contracts does not result from the application of general tax principles. It is also clear, however, that Congress has considered this issue and decided to retain favorable treatment for life insurance contracts. The following policy justifications have been cited by the insurance industry in support of retaining the tax advantage: (a) it encourages the purchase and maintenance of life insurance protection, particularly in the years after retirement; (b) it encourages long-term savings; (c) it protects policyholders from being subject to tax before they have received cash with which to pay the tax; and (d) it avoids complexity and policyholder confusion that would result from attempting to impose a tax.

The first policy justification has been viewed as the most compelling, as illustrated by the removal in 1984 of the preference for contracts that contain an insufficient insurance element. The Treasury Department has in the past recognized and continues to recognize the social benefits of encouraging insurance protection. In the event of the death of a working spouse, life insurance proceeds can be a source of support for the surviving spouse and minor children, and can enable the survivors to maintain their standard of living. In certain cases, life insurance may enable the surviving spouse and minor children to avoid becoming dependent on governmental assistance, thereby relieving government of an obligation it otherwise would have to assume.

B. Proposals to Revise Definition of Life Insurance

The adoption of a statutory definition of life insurance in the 1984 Act prevented investment oriented contracts that were nominally structured as life insurance contracts, but that bore little resemblance to traditional life insurance contracts, from qualifying for favorable tax treatment. Nonetheless, several factors make it possible for contracts with a substantial investment component to qualify under section 7702. Most important, single premium contracts are expressly permitted under section 7702. In addition, the actuarial tests of that section permit the use of conservative interest rate assumptions and do not limit the assumed mortality charges. Understated interest assumptions and overstated mortality assumptions each have the effect of increasing the initial cash value and reducing the amount of insurance risk.

The investment orientation of a life insurance contract may be quantified by examining the ratio of investment income earned on the cash value of the contract to the contract's mortality charges (i.e., the cost of insurance protection). Table 4 illustrates the ratio of investment income to mortality charges for level premium, 10-pay premium (i.e., level premiums paid over a 10-year period), and single premium contracts purchased by a 55-year old individual. If the contracts are priced using a 6 percent interest assumption and actually earn investment income at that rate, the ratio of investment income to mortality costs during the 20-year period following the purchase of the policy is 0.64 in the case of the level premium policy, 1.51 in the case of the 10-premium policy, and 2.13 in the case of the single premium policy. The disparity is more pronounced in the situation where an 8 percent return is earned: the ratio is 1.15 for the level premium policy, 3.25 for the 10-premium policy, and 5.81 for the single premium policy. As indicated on Table 4, the ratio of investment income to mortality costs is even higher if actual mortality experience is less than assumed.

We believe it is appropriate to question whether a tax benefit should be provided in cases where the investment earnings on a contract substantially exceed the mortality charges under the contract. As past experience has made clear, however, this is a question more easily asked than answered. It would be possible to make several technical changes to section 7702 that would restrict the permissible investment orientation of life insurance contracts without affecting insurance contracts (including single premium contracts) purchased for insurance purposes. For example, the unrealistically low interest rate assumption under the cash value accumulation test could be increased, the generous cash value corridor under the guideline premium/cash value corridor test could be made more restrictive, and statutory limits on assumed mortality charges could be imposed.

Amending section 7702 to prevent single premium and other contracts that are funded more rapidly than over a specified period from qualifying as insurance would be a more fundamental change. It would not be unreasonable for Congress to conclude that single premium and other limited premium contracts are, by their nature, more appropriately treated as investment contracts than as insurance contracts, and hence should not benefit from the tax preference for insurance contracts. There are, however, significant arguments against such a change.

First, single premium contracts have certain advantages wholly independent of the deferral of tax on inside build-up. In particular, it has been suggested that the marketing and distribution system for single premium contracts is more efficient than the system for level premium policies. Second, if a single premium contract is held until death, the policy goals of providing funds for beneficiaries and promoting long-term savings have been satisfied. Third, it is somewhat incongruous to tax inside build-up on single premium policies on the ground that such policies are unduly investment oriented, while continuing to permit deferral of tax on the inside build-up on deferred annuity contracts, which are pure savings vehicles. The incongruity may be explained by the more favorable life insurance contract distribution rules (and the tax exemption for investment income on life insurance contracts held until death). As discussed below, however, it may be more appropriate to revise the distribution rules for some or all life insurance contracts than to eliminate the deferral of tax entirely.

C. Proposals to Revise Treatment of Loans and Distributions

Revising the definition of life insurance to eliminate the tax preference for single premium and similar contracts would require a careful reconsideration of the policy goals that were presumably relied upon by Congress in continuing the tax deferral permissible through life insurance contracts. On the other hand, it can be argued that revising the treatment of loans and distributions with respect to life insurance contracts would be consistent with the policies supporting tax-favored treatment of life insurance. The withdrawal of cash from a life insurance contract, whether through a loan or an actual distribution, reduces the net death benefits payable under the contract by the amount of the withdrawal, reduces the long-term savings under the contract by the amount of the withdrawal, and makes available to the policyholder sufficient funds to pay any tax liability triggered by the distribution.

The loan and distribution rules applicable to life insurance contracts do not provide any disincentive to the withdrawal of cash from life insurance contracts. The failure to discourage cash withdrawals from life insurance contracts contrasts with the treatment of deferred annuity contracts and IRAs, where all distributions are taxed in whole or in part, loans are treated as taxable distributions or are prohibited, and a penalty tax is imposed on premature withdrawals. At least with respect to investment oriented life insurance contracts, we see no valid tax policy reasons for the absence of similar restrictions on life insurance contracts.

All cash value policies have a significant investment element. Accordingly, it is arguable that revised distribution rules should apply to all cash value policies, as proposed in H.R. 3441. As discussed earlier, however, the investment orientation of single premium and other limited premium contracts is substantially greater than the investment orientation of level premium policies. The justification for imposing distribution rules similar to those that apply to deferred annuities, in order to recapture the tax preference where the preferred investment has not been used as intended, is significantly stronger in the case of limited premium contracts than in the case of level premium contracts. For this reason, it may well be appropriate to limit distribution restrictions to limited premium contracts.

D. Proposals to Revise Treatment of Certain Policyholders

Life insurance contracts owned by businesses raise two particular tax policy concerns. First, subject to the $50,000 per insured limit of section 264(a)(4), interest on policy loans is generally deductible by the business. The allowance of a deduction for the interest, while the corresponding inside build-up on the policy is not taxed currently, serves to shelter other income from tax. The purchase by businesses of life insurance contracts for the principal purpose of obtaining this tax shelter was common prior to the Tax Reform Act and continues to occur under current law. The only change in practice is that, in order to stay below the $50,000 ceiling, businesses desiring to utilize the tax shelter are forced to purchase smaller policies on a larger number of employees.

The second concern is the use of life insurance contracts by businesses to fund deferred compensation, health benefits, and other future liabilities unrelated to death benefits. The ability to use tax free inside build-up to fund deferred compensation may act as a disincentive to provide benefits through qualified plans, which are subject to nondiscrimination rules and other restrictions. With respect to the funding of health benefits and similar future liabilities, Congress has specifically decided not to permit the funding of such liabilities on a tax-favored basis. The use of life insurance to fund these benefits is inconsistent with that decision.

The ability of businesses to invest in life insurance contracts solely for the purpose of generating a tax shelter or funding non-death benefit liabilities is not without limit. A policy owned by a business may not qualify as insurance under state law if the business does not have an "insurable interest" in the life of the insured individual. Failure to qualify as insurance under state law would preclude the contract from qualifying as insurance under section 7702. We do not, however, regard the uncertain effect of state law characterization as a sufficient deterrent to business use of life insurance contracts for investment purposes unrelated to the provision of death benefits.

Accordingly, we believe that the use of life insurance contracts by businesses for purposes other than the funding of death benefits is an area that may warrant examination by Congress. In particular, it may be appropriate to examine whether the limits imposed by the Tax Reform Act on the deduction of interest on life insurance policy loans are serving their intended purpose.

This concludes my prepared remarks. I would be pleased to respond to your questions.

Chairman RANGEL. Did you give me your views on what the Treasury might think of retroactivity?

Mr. ROSS. Mr. Chairman, let me address that in a general way, since I think the question depends very much on the specifics of the eventual approach, if any, that is adopted by the committee.

If the committee were to pursue an approach to change the definition of life insurance, so that certain contracts simply were no longer treated as insurance, I think it would be appropriate to grandfather existing contracts and make that rule one that is prospective only in application.

Now, if the approach is different and it attempts to change the rules for distributions or loans on policies, it may be justified to take a somewhat different approach and not grandfather all the policies, but simply premiums paid on existing policies. That approach was taken, as Mr. Stark indicated earlier, when the rules applicable to distribution for tax deferred annuities were changed. In effect, there was a grandfathering of prior investment but no grandfathering of all prior policies. Under that approach—again, if the committee were to pursue an approach that dealt with loans and distributions—some degree of retroactivity in that sense might be defensible.

Chairman RANGEL. Do you have any other proposals for changing the tax treatment of corporate-owned life insurance?

Mr. ROSS. I am sorry? Any others?

Chairman RANGEL. Any other proposals for changing the tax treatment of corporate-owned life insurance?

You suggested we might revisit the loan rules for corporate-owned life insurance?

Mr. ROSS. I did not—Mr. Chairman; I did not offer an specific proposal in this regard. I meant to identify two areas of concern.

I think there is an area that warrants examination. While we are not prepared at this time to offer a specific proposal, we would be pleased to work with the committee in examining whether any changes in this area are appropriate.

Again, the concerns I identified in my testimony were whether the loan limitations established in 1986 are, in fact, serving their intended purpose or whether corporations are taking out more policies, smaller policies, but on a greater number of employees, and achieving the same purpose as prior to the $50,000 limit.

Chairman RANGEL. You have suggested limiting deductibility for interest on life insurance policy loans would deter the use of life insurance contracts for purposes other than funding the death benefit.

Already under existence there are limits of this nature under present law which although they do not cover all borrowing of the life insurance contacts, have these limits had any effect on the growth of investment oriented life insurance?

Mr. ROSS. Are you referring to the $50,000 limit on non-individual owned policies?

Chairman RANGEL. Well, the staff was interested in that as it relates to the $50,000 rule.

Mr. ROSS. Mr. Chairman, there clearly has been some effect. I would not want to suggest the 1986 changes have been without consequence. I think they have.

The question we want to raise is whether they went far enough in limiting what I think was an inappropriate use of life insurance. That is a question I believe deserves future examination.

I do not know if we have any specific data that at this time we would present. That is something we would certainly be happy to pursue.

Chairman RANGEL. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

On page 12, Mr. Ross, of your testimony, where—in section C, you are talking about the proposal to revise the treatment of loans and distributions.

You make the statement there that revising the definition of life insurance to eliminate the tax preference for single-premium and similar contacts would require a careful reconsideration of the policy goals that were presumably relied upon by Congress in continuing the tax deferral permissible through life insurance contacts.

When I was talking with Mr. Stark earlier today about what is the proper ratio of investment, that is acceptable, Mr. Stark referred back to the 1984 act, and some other activities. I can't recall that we determined that the policy considerations was to eliminate single-premiums in 1984.

Mr. ROSS. In fact, quite clearly it was not. The statute contemplates single-premium policies.

Mr. FLIPPO. Front-end loading and the rest of it was permitted? What I am, I guess I am trying to probe here is what is your view of what those basic policy considerations were on which the committee relied to continue the preferred tax treatment of inside buildup?

Mr. ROSS. I think Mr. Stark phrased it rather well. There clearly is a mixture, I suppose, of motives in this area.

Clearly driving the very special tax treatment insurance receives, I believe, is an intention to encourage individuals to get life insurance. Current law allows favorable tax treatment, of investment income primarily, for that purpose.

It does not, however, structure the insurance choices that a policyholder has so as to limit the benefits simply to that purpose.

I think that is the concern that was initially addressed in 1984, and I suppose the question is whether the 1984 restrictions went far enough. There was an attempt to say that if the investment features of the contract are excessive, it is no longer insurance.

I think the question that this committee is now taking up is whether that attempt did go far enough; whether you can still with the 1984 restrictions devise a policy that is predominantly, primarily, whatever sort of standard you want to suggest, an investment and not an attempt to acquire insurance.

I think there are some indications, the promotional literature on single-premium policies is perhaps the most blatant indication, that there is that ability under current law to devise a policy that is essentially an investment and has very little connection with insurance.

Mr. FLIPPO. Can you give us any idea how much revenue is involve in this issue?

Mr. Ross. Again, it depends upon the approach you take. There is enormous revenue in just the general question of inside buildup. No one is talking about changing those rules. What I think we are looking at is a much smaller amount of revenue.

Again, it would depend on the approach one took and it would also depend upon the effective date. I think at the outside, you are in the area of $100 to $200 million a year.

Mr. Flippo. There are several ways you can reduce that ratio of investment to premium.

Mr. Ross. Yes.

Mr. Flippo. Have you examined any of those?

Mr. Ross. Certainly in general terms. One of the suggestions I made in my testimony was requiring more realistic actuarial assumptions.

Within the present structure in section 7702, very low interest rate assumptions are permitted, to some extent an unrealistic mortality assumption is made.

If those were tightened a bit, that would have the effect of restricting investment orientation.

Mr. Flippo. Thank you, Mr. Chairman.

Chairman Rangel. Anything else?

Mrs. Kennelly.

Mrs. Kennelly. Yes, Mr. Chairman.

Mr. Ross, you just said that no one is talking about taxing inside buildup.

From you testimony, I obviously picked up you agreed there is a reason for these hearings. There is a possibility of a real problem on single-premium life insurance.

By saying you don't want to change any of the rules as they exist now, are you saying—or is Treasury endorsing the idea we should not be looking at the tax treatment of ordinary life insurance at this time?

Mr. Ross. I think clearly the focus ought to be on investment orientation. To some extent even the question of treating loans and distributions with respect to ordinary policies is arguably something that was addressed in tax reform.

I think it is questionable whether we ought to get back into that type of issue at this time. It seems to me the focus of this committee's effort ought to be on investment oriented policies.

Mrs. Kennelly. Thank you, Mr. Ross.

Chairman Rangel. Mr. Dorgan.

Mr. Dorgan. Mr. Chairman, Mr. Ross, thank you very much for your testimony.

I have a question about retroactivity. If at some point the Ways and Means Committee decides to do something what is your general impression about how it should be done? Only prospectively?

In other words, let's discuss retroactive applications in tax law? Would you address that for me?

Mr. Ross. Certainly, Mr. Dorgan.

I think the question of retroactivity depends very much on the approach that is taken. If the committee were to change the rules defining insurance and thus say certain policies simply are not insurance, they are subject to tax currently, that seems to me to be a change that should only be made prospectively. Any existing policy out to be grandfathered from that change in law.

If the approach taken were instead to say, let's change the rules on distributions or on loans against policies; I think there is precedent for an approach that is to some extent, in some sense retroactive, that is it would apply to old policies.

It would be appropriate, I think, to grandfather prior investments in old policies. Indeed, it could be appropriate to grandfather old policies altogether.

I simply would not—if the approach is not to try to redefine what is life insurance, but to change the distribution rules—there is a basis for saying we aren't going to simply say old policies, whenever entered into, and however much in terms of future premiums are at stake are protected for all time.

As Mr. Stark suggested, when the rules for distributions with respect to deferred annuities were changed, there was sort of limited retroactivity. That is, old policies were to some extent affected. But prior investment was effectively grandfathered.

Prior investment in those old policies, that sort of thing could, depending upon the rules, apply and could be defensible here.

Mr. **Dorgan**. Would it be fair to characterize Treasury's position as generally changes ought to be prospective?

Mr. **Ross**. Certainly in a general sense. You have the question of what is retroactive and what is prospective.

If you draw the line and say we will affect old policies but not old investment, it seems that is a defensible approach, again depending upon the nature of the change you adopt.

Mr. **Dorgan**. Thank you.

Mr. **Flippo** [presiding]. Thank you.

Mr. **McGrath**. Thank you, Mr. Flippo.

Mr. Ross, in your testimony and some of your answers you cited some of the abuses and some of the ads regarding the investment nature of this product. I wonder if Treasury could elaborate on these points?

For instance, I saw those ads, too. Independently, I have gone out and tried to secure a product like that advertised in some of our larger newspapers.

I have not been able to find any that matched them entirely.

I heard about policy loans. I wonder if the Treasury has any information which could quantify the perceived abuses that were indicated in those ads?

Mr. **Ross**. I don't know—we do not have any definitive set of the promotional materials. So I am not sure what standard to apply in answering whether or not those materials stated accurately what you could achieve with a single-premium policy. We have attempted to quantify the tax benefits of the single-premium policy.

There is a table attached to my testimony, it is actually the last page of the printed testimony, which sets out sort of a rule of thumb measure of tax benefit involved in the ratio of investment income on a policy in comparison with the cost on the policy for actual life insurance protection.

It stated different assumptions about interest rate, mortality charges. That table sets forth the ratio of investment income to the life insurance component.

As you can see, at least on one set of assumptions for a single-premium policy, that ratio gets as high as 7.86 to 1, where at the others extreme, a whole life policy on more conservative assumptions, the ratio is under 1. That simply gives a flavor of how much tax benefit is conceivably available in the single-premium policy.

Whether that is abusive, I suppose, is another question. If a single-premium policy were held until maturity or until the death of the insured and there was never any withdrawal from that policy, you could say that is a perfectly defensible use of insurance. That was simply an intent to get insurance protection. In fact, the proceeds all went to death benefits.

That is consistent with the purpose in having favorable rules for life insurance.

But I think it is hard simply to look at the policy on its face and decide whether that policy is abusive. If, as I think some of the promotional materials suggest, the policy were secured, you immediately borrowed out everything you put into it, that certainly sounds like you are not thinking about insurance. You are thinking about investment.

Whether, in fact, that is the practice with single-premium policies I am less certain. I don't have specific information as to whether those ads reflect what is actually done.

Mr. McGRATH. Let me see if I can make this very clear. So, it is not the policy or intent of the Treasury to seek changes in the tax treatment of life insurance products that are not viewed as abusive.

In other words, you are not interested in attacking some of the things that Congressman Stark would for other life insurance products; am I correct?

Mr. ROSS. I think it is best to focus on investment-oriented policies, yes. I think I would agree with that.

Mr. McGRATH. I think I will stop right here.

Mr. FLIPPO. Mr. Andrews?

Mr. ANDREWS. Dennis, let me follow up a little bit to be sure I understand your written testimony. Are you saying to us that we should adopt an approach that really targets only single premium insurance policies and applies in general the Stark-Gradison approach just to those policies? Is that a correct statement?

Mr. ROSS. Let me just embellish it a bit. It is certainly not far off, depending upon what you mean by single premium. I would use the term investment-oriented. I think that would extend beyond the pure case of a single premium policy. It might extend to—there are various approaches to defining investment-oriented.

You could insist on a minimum of 10 level annual premiums. If you have less than that, if the policy is more front-loaded than that, it would be investment-oriented. I should say that I certainly understand the rationale for Mr. Stark's proposal.

Indeed, I think you can argue the restrictions he would apply to all policies would serve to underscore the reasons we favor life insurance. They would encourage the insurance aspect of it and encourage the savings aspect of it.

I think our concern in saying let's focus on investment-oriented policies is not to reopen on a broad scale the taxation of life insurance. That is an issue that had heated debate in 1984 and 1986. Arguably, it is a question one could say was settled in some sense at least for the near term in the tax reform bill.

The administration is strongly opposed to reopening tax reform in any substantial way.

I think on those sorts of considerations, we think it more prudent to proceed on what may well be a consensus of view—that single premium or investment-oriented policies go beyond what we intend to offer in the way of tax advantage for life insurance.

Mr. ANDREWS. Thank you.

Mr. FLIPPO. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Ross, help me understand this process. Let me give you this example, and maybe you could help me.

Let's assume the carrying costs and the mortality costs, the insurance costs are a good 2 percent. Inflation is about 6 percent. The return on investment is about 8 percent. How is the investor in the policy better off? How has he improved his position?

I assume the cash value goes up by 6 percent under that scenario, which is the same as the inflation rate. In real dollars, has the owner of that policy gained anything at all?

Mr. ROSS. He has acquired insurance protection on a basis that is not taxed. If someone makes those payments with their earnings, their salary, it is not a deductible cost. You could say there is that benefit.

But I think you are right to think about the question of inflation, how we tax income from capital. That is a troubling question. In general, the answer in the system is that we don't account for inflation in deciding how we are going to tax income.

If you had a savings account and it pays you an 8-percent return, your world is a 6-percent inflation, you are taxed on an 8-percent return, not a 2-percent return. You could make the argument your income is that 2 percent.

Even if you say, however, that we are not taxing inside buildup or otherwise taxing distributions or whatever in connection with life insurance, as some sort of allowance for inflation, it creates an anomaly or distortion in comparison with how we tax other investment opportunities.

Mr. BROWN. But you see, what we are looking at here, I mean this process is driven by the perception that somehow, the taxpayers are getting a real bonanza. You quoted the figure of $5.4 billion, $5.2 billion in terms of tax expenditures. Tell me, in terms of calculating tax expenditures, is there an adjustment made for inflation?

Mr. ROSS. No.

Mr. BROWN. So, the gain the so-called investor or holder of those insurance policies is getting may be in real terms nonexistent?

Mr. ROSS. Again, yes, if you make that adjustment for inflation. Again, other investments in the economy don't have an adjustment for inflation. So, the discrepancy is in that sense a relative one.

Mr. BROWN. As you know, when we had capital gains, part of the justification for capital gains treatment was an adjustment for inflation. We have done indexing in a number of areas. The point is this: Before we talk about this as a big bonanza, I think we ought to stop and ask ourselves, is the person investing in these policies coming out better at the end than at the start?

Do you have any figures that calculate an average return on investment for money put into these policies?

Mr. Ross. We might.

Mr. **Brown**. If your shop does, supply it. I think it would be helpful to the committee. Along with that, perhaps, a comparison of those returns with the inflation rate.

Mr. Ross. Real rate of return?

Mr. **Brown**. Yes.

My impression is in the seventies, perhaps even in the sixties, the inflation rate was fairly close to the average return on investments of this kind. You may be able to confirm or deny ~~that.~~ That has changed somewhat here. My guess is what we are talking about here is a situation in which the policyowner, in terms of real dollars, comes out with the same or less than they put in.

Mr. Ross. That is unfortunately too often the case in a number of areas. In the seventies, you saw with respect to capital assets many cases where negative income was being taxed. There was actually a real loss experienced on the investment. The capital gain preference was not sufficient to reflect that as an inflation adjustment.

It is obviously a rough adjustment. Conceivably, the same is true with respect to insurance. There was no real gain on the contract.

Mr. **Brown**. Do you specify in the tax expenditures calculation that you used, what the underlying assumptions are?

Mr. Ross. Yes, clearly. I am not sure whether the assumption is it would be essentially the same basket of assets as the insurance company invests in, or whether it would be assumed an alternative investment. Clearly, it is in some sort of taxable—suppose you could—you also must make an assumption that it will flow into other investments that are tax-preferred, investments that don't yield current income, that simply accrue gain.

Some of it might flow into not currently taxable investments. Presumably the bulk would flow into investments that produced a current taxable yield.

Mr. **Brown**. What portion of life insurance policies are cashed in and therefore taxes paid, versus those that are passed on by death benefits?

Mr. Ross. I do not know the answer to that. I think we can supply you with that.

[The following was subsequently received:]

POLICY TERMINATIONS

We do not have figures on the liklihood that a given policy will be held until death or will be disposed of before death. We do, however, have annual figures on the percentage of policies terminated by death or otherwise. During 1986, less than 1.0 percent of outstanding ordinary life insurance policies were terminated by reason of the death of the insured. During the same year, the voluntary termination rate for all policies was 11.1 percent. The termination rate was 21.7 percent for policies in force for less than 2 years and 9.0 percent for policies in force for more than 2 years.

Mr. **Brown**. Do the assumptions used in the tax expenditure figures take into account future taxes to be paid?

Mr. Ross. Well, I believe there would have to be some sort of adjustment for the future tax paid; and how that would affect each annual accounting period, I am not sure.

Mr. McGrath. Will the gentleman yield?

One of the abuses I understand that is going to be testified on today is that there are all kinds of loans being taken on these policies. From what I have been able to determine from my own independent investigation of this area there aren't that many loans being taken out on single premium policies—the loan ratio or the percentage of loans is somewhere less than 5 percent.

I just wonder whether or not that loss of revenue, $5.4 billion, has been done with real numbers or whether it is some estimator's guess.

Mr. Ross. Guess is not a kind word. I think there clearly is some subjective evaluation, specifically as to how the investment, if not taxed as life insurance, would otherwise be directed. I think it is not affected by an assumption about loans, since the tax expenditure number is based on an assumption that the income would be taxed currently regardless.

Mr. McGrath. Given the penchant for Americans to spend rather than save, is it realistic to believe that at a savings rate of 3 to 4 percent—if it is that—the money spent on single premium policies would be spent and not saved were it not for these policies?

Mr. Ross. That is certainly one of the arguments. Focusing on distribution rules, though, it does not promote savings. I think Mr. Stark made a good point here. It does not promote savings to allow premature distributions, to allow borrowing against the policy, since those funds are now available for consumption or any other purpose the policyholder might have.

If you really wanted to promote savings, you would presumably do as we do with respect to IRAs or deferred annuities. That is insist, indeed put in tax disincentives against distributions or withdrawals from the savings, and that is not done with respect to life insurance.

Mr. McGrath. Thank you for yielding.

Mr. Brown. Thank you, Mr. Chairman.

Mr. Flippo. Thank you.

Mr. Downey.

Mr. Downey. Thank you, Mr. Chairman. I will not take the subcommittee's time, but I have several questions.

I just want to say, I hope as the committee proceeds that we keep in mind there is a problem that needs to be fixed. There are abuses, but there are also problems that don't need to be fixed. I hope we focus our attention on the problems and not on the other possible opportunities.

Mr. Flippo. The gentleman from California.

Mr. Stark. I just want to thank the witness, Mr. Chairman, and graciously accept the endorsement.

Mr. Flippo. Thank you.

Thank you, Mr. Ross, for your testimony.

Our next witness is with the U.S. General Accounting Office, Ms. Stathis, the Associate Director of the General Government Division, accompanied by Mr. Gandhi, Group Director of Tax Policy.

We are delighted to have you. Proceed as you deem appropriate.

STATEMENT OF JENNIE S. STATHIS, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY NATWAR M. GANDHI, GROUP DIRECTOR, TAX POLICY

Ms. STATHIS. We are delighted to be here this morning. We are going to present some slides to summarize our statement, and submit our written statement for the record.

Chairman RANGEL. Without objection.

Ms. STATHIS. As we have been discussing earlier, as part of the Deficit Reduction Act, Congress did eliminate tax benefits of products that offered large initial investments or high-investment returns, and maximized advantages of tax deferral inherent to life insurance.

[Slide.]

Ms. STATHIS. Section 7702 of the code defines life insurance as any contract that meets either of these two tests. The first is called the cash value accumulation test, in which a policy's cash value may never exceed the net single premium needed to pay all future death benefits.

Under the second, the guideline premium/cash value corridor test, premiums cannot exceed the amount needed to fund the death benefit, and the death benefits cannot be less than a percentage of the cash value. This percentage decreases as the age of the insured increases.

This test is important to one of our alternative recommendations, which I will discuss later.

[Slide.]

Ms. STATHIS. There are certain tax benefits associated with all life insurance and the significance of the two tests is that as long as the policy meets one of them, the policyholder is entitled to these tax benefits.

[Slide.]

Ms. STATHIS. Now, some companies market the single premium products as a substitute for certificates of deposit, as a substitute for municipal bonds, as a substitute for annuities, for mutual funds; but they always provide a death benefit and thus, they are structured to qualify as life insurance under the law.

[Slide.]

Ms. STATHIS. The difference between the single premium policies and more traditional life insurance is the large premium that is paid up front. This provides a proportionately large investment fund.

[Slide.]

Ms. STATHIS. There are several types of single premium policies. One of the more common ones is a single premium whole life, in which the policy offers a market-sensitive interest rate that is guaranteed for a fixed period, usually 1 to 5 years.

A second type of product is called single premium variable life, and in this type of a policy, you are not guaranteed a specific interest rate. Instead, the policyholder can choose from among several investment options; for example, a growth stock portfolio, or a money market fund, or a bond portfolio.

The cash value appreciation of the policy is then tied to the performance of whichever fund you select.

[Slide.]

Ms. STATHIS. We compared interest rates on the single premium policies reported in two studies, one done by A.M. Best and one by the Life Insurance Marketing Research Association. We compared them with tax-exempt bonds and with taxable bonds, and found that the rates offered were competitive with these other investment products.

[Slide.]

Ms. STATHIS. Now, often, the policies offer low-cost loans in which the interest rate credited to the account equals the interest rate charged to borrow, or else the loans cost 1 to 2 percentage points. Loans are available relatively early in the life of the contract.

[Slide.]

Ms. STATHIS. This graph shows the growth of single-premium products in comparison with ordinary life insurance. It shows that between 1984 and 1987, sales grew 850 percent from $1 billion to $9.5 billion. Over the same period, ordinary life grew 20 percent, from $8.3 to $10 billion.

Another way of saying this is that for every dollar of new sales, 50 cents came from single premiums and 50 cents came from periodic pay.

[Slide.]

Ms. STATHIS. Why have the products grown so dramatically? Well, industry researchers attribute this to the competitive nature of the investment product, the tax sheltering that is provided, as well as the life insurance benefits at the same time that other types of traditional tax shelters have been eliminated or severely curtailed by changes in the tax law.

[Slide.]

Ms. STATHIS. These policies appear popular on the investment market, since on the basis of premiums, about 52 percent of them are sold by stockbrokers. It appears that they are geared to individuals at higher income levels, because the average premium is $31,000, in contrast to the $548 average annual premium on ordinary life.

[Slide.]

Ms. STATHIS. Who are the buyers? They are older than those who buy periodic pay life insurance. The average age of the buyer is about 53. The average age of an ordinary life buyer is in the early thirties.

[Slide.]

Ms. STATHIS. And with the large initial premiums, it is not surprising that 49 percent of the buyers had either more than $75,000 in employment income or else had only unearned income. This is somewhat different also from ordinary life in which the prevalence of folks with more than $75,000 in employment income is much smaller.

Given the characteristics of the policies, they appear similar to the reason for which Congress tightened the tax law and deserve some attention. They are products that have large initial premiums and a sizable investment component. They provide low cost loans that allow policy owners income without reporting it on a tax return.

The loans erode the death benefit and if not repaid before the death of the insured, can defeat the purpose of life insurance. We think such loans tend to be similar to distributions from annuity contracts which are taxed.

Consequently, we are recommending that you consider legislative remedies to eliminate the tax advantage associated with the investment-oriented products.

[Slide.]

Ms. Stathis. We offered in our report two different approaches. As you heard this morning, there are probably several others. The first approach would treat single premium loans like distributions from annuity contracts.

Thus, you would assure like treatment of similar products. This would be a relatively clear-cut change, except that we know one dilemma: That would be defining what is a single premium policy.

And one possibility that there would be—a suggestion that Dennis Ross mentioned earlier—putting in some characteristic on the basis of a number of level payments.

[Slide.]

Ms. Stathis. This would be a somewhat harsher change than what we show as a second approach. In this one, you would disqualify contracts only if the policy loans reduced death benefits below certain levels. We have an example of a policy that shows how this might work.

[Slide.]

Ms. Stathis. This first table depicts an actual single premium policy that was offered a 55-year-old male. In this policy, he was to pay a $50,000 premium. He was guaranteed an 8¾-percent interest rate for 1 year. The contract offered a 4-percent minimum interest rate.

The various columns that we have, after the year column, show the accumulated value of the account at various years. We show in the next column the interest that is earned on the original premium and for our purposes of illustration, we are assuming that this policyholder borrows at the beginning of each year an amount equal to that earned in 1 year on the original single premium.

In the third column, we show how that loan accumulates over a period of years in the account. The last column shows the death benefit that is also growing. If you look down at the year 20—and this would be when this individual would be 75 years old—you will see that the account has accumulated to a value of $250,000.

He is again taking out a $4,000 loan, and his cumulative loan at the end of that year has mounted to more than $195,000. The death benefit at the end of that year is now more than $267,000.

[Slide.]

Ms. Stathis. In this table, we illustrate the effect on the policy's death benefits, if the policyholder borrows the full amount earned in the preceding year, and you see in the first column, the stated death benefit that is provided in the contract.

The next column shows what a beneficiary would actually receive, considering the loan that has accumulated on the contract. In the next column, we have three calculations of the ratio of death benefit to the accumulated account value. In the last column, you see the statutory minimum.

This is the corridor test that life insurance policies have to meet. What we are titling the actual column is a calculation of the gross or stated death benefit as it is currently done, and you will see that this policy meets the statutory minimum in every year.

Now, our second alternative approach is depicted in the column that is headed minus loans. If this ratio were calculated by first subtracting loans from the contract, you would see that this particular policy would no longer meet the definition of insurance at some point in the fifth year.

In the third chart, we show what would have to be done in order to meet the statutory definition. In the fifth year, the policyholder would no longer be able to borrow total interest earned, and in the sixth year, the policyholder would have to start repaying the loan.

The advantage of this approach is that it would maintain borrowing as a feature of life insurance, but it would require loan repayment and insure that loans really are loans, and therefore, it would protect the actual death benefit that would be received.

That concludes my summary. At my left is Dr. Natwar Gandhi, our director for work in this area. We would be happy to respond to your questions.

[The statement of Ms. Stathis follows:]

STATEMENT OF JENNIE S. STATHIS, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

We are pleased to have the opportunity to assist the Subcommittee in its deliberations on investment-oriented life insurance products. We will address our remarks today to the sales, features and tax treatment of single premium life insurance and discuss some potential approaches for changing the tax-favored status of single premium life products. In October 1987, we issued a report titled Taxation of Single Premium Life Insurance (GAO/GGD-88-9BR, October 1987).

Single premium life insurance is a term used to describe a variety of life insurance products that give policyholders certain tax and investment benefits. The policies, which allow a relatively large single premium to be paid up front, combine death benefits with earnings which accumulate tax-free. Policyholders can also obtain loans against the policies at little or no cost because the income on funds invested is used to offset the interest charged to borrow. Thus, the policies provide a device for capturing investment income without reflecting it on an income tax return.

The attractive tax and investment features of single premium life insurance, combined with the loss of tax benefits on other financial vehicles, have resulted in dramatic growth in the sales of single premium products. Between 1984 and 1987, single premium life sales grew 850 percent, from $1.0 billion to $9.5 billion. During the same time, sales of ordinary premium life insurance grew 20 percent, from $8.3 billion to $10.0 billion.

Before I further discuss our proposed approaches for eliminating the tax advantages of single premium life insurance, I would like to provide some background on the tax treatment, sales and buyers of the products.

TAX LAWS AFFECTING LIFE INSURANCE

As part of the Deficit Reduction Act of 1984, Congress enacted statutory language that defined life insurance for tax purposes. The definition was adopted in response to concern over the proliferation of investment-oriented life insurance, which was designed to pay high investment yields, tax-free, to policyholders. The language amended the Internal Revenue Code to eliminate the tax benefits of life insurance products that (1) offered large initial investments or high investment returns and (2) maximized the advantages of tax deferral inherent to life insurance.

Section 7702 of the Code defines as life insurance any policy that meets either of two conditions or tests--the cash value accumulation test, or the guideline premium and cash value corridor test. Under the cash value accumulation test, a policy's cash value may never be more than the net single premium needed to pay all future death benefits. Under the guideline premium and cash value corridor test, the premium cannot exceed the amount needed to fund the death benefit; and the death benefit cannot be less than a set proportion of the policy's cash value depending on the age of the insured.

As long as a life insurance policy qualifies under either of the two tests, the policyholder is afforded certain tax benefits. First and foremost, the inside build-up or undistributed income on the policyholder's cash value is not subject to taxation. Second, death benefits are excluded from income so that neither the policyholder nor the beneficiary is taxed on the proceeds of the policy if paid to the beneficiary upon the death of the insured. Third, policyholders are allowed to take earnings from the policy in the form of loans without being taxed. Policy loans are taxed only when the policyholder has outstanding loans and surrenders part or all of the policy. When this occurs, outstanding loans and any other distributions resulting from the surrender are treated as income, but only to the extent that the amounts borrowed or distributed exceed the amount paid into the contract.

Like other life insurance products, single premium life is designed to qualify as life insurance under the law. In this way, policyholders enjoy all the tax benefits afforded life insurance policies including tax-free accumulation of income, tax-exempt death benefits, and tax-free policy loans. However, unlike more traditional products, single premium policies require one large premium to be paid up front. This premium--usually $5,000 or more--provides life insurance and a proportionately large investment fund. Thus, more funds are immediately available to generate income; inside build-up occurs more rapidly; and the policyholder is more quickly able to access large sums of money through policy loans.

CHARACTERISTICS OF SINGLE PREMIUM LIFE INSURANCE

Over the last few years, numerous companies have begun selling different varieties of single premium life policies. One of the more common of these products is single premium whole life, which offers the policyholder a market-sensitive interest rate on cash values for a guaranteed fixed duration--usually 1 to 5 years. Once the guarantee period ends, the insurer declares a new interest rate for an additional fixed period. Another single premium product, single premium variable life, does not guarantee current interest rates for a specific period. Instead, cash value appreciation is tied to the performance of selected investment funds.

Regardless of the type of single premium life insurance, two key characteristics stand out. The policies offer (1) market-sensitive, competitive interest rates on cash values and (2) low cost or even no-cost loans against the interest accrued. In reviewing these characteristics, we looked at separate studies compiled by A.M. Best and the Life Insurance Marketing and Research Association (LIMRA). We computed that the rate declared on 24 fixed rate policies reported by Best in September 1986 averaged 8.05 percent. Similarly, LIMRA reported that, as of December 1986, the interest rate on fixed rate policies offered by 32 companies averaged 7.7 percent. When we compared these rates to the average rate of return on tax-exempt and taxable bonds for all of 1986 (7.31 and 9.71 percent respectively), we found that, as an investment, fixed rate single premium life insurance was competitive with some of the more popular investment products.

In regard to policy loans, Best and LIMRA both highlighted the fact that the majority of the products offer low or no-cost loans. For example, in a 1987 study, Best reported that 30 of 42 companies with fixed rate single premium products offered zero net-cost loans whereby the interest rate credited to the policy on borrowed funds equaled the rate charged to borrow. The remainder offered loans at rates generally 1 to 2 percentage points higher than the interest credited to the borrowed funds. Likewise, LIMRA reported that 10 of 13 companies that sold fixed rate products during 1985 offered zero net-cost loans. LIMRA also reported that 5 of the companies allowed immediate policy loans; and 8 allowed loans after the first policy year.

SALES AND BUYERS OF SINGLE PREMIUM LIFE INSURANCE

Over the last four years, single premium life policies have become popular. By the end of 1987, insurance companies collected almost as much revenue from single premium sales as from first-year sales of periodic pay ordinary life insurance. Between 1984 and 1987, single premium sales grew 850 percent from $1.0 billion to $9.5 billion. During the same time, the premiums on sales of periodic-pay life insurance products grew 20 percent from $8.3 billion to $10.0 billion.

Life insurance industry researchers attribute much of the dramatic growth in single premium life sales to attractive investment, tax and life insurance features. But they also cite recent legislation that resulted in the loss of traditional tax shelters. LIMRA points to the Tax Equity and Fiscal Responsibility Act of 1982 which eliminated favorable tax-treatment of withdrawals from single premium annuities. Best cites "severe limitations imposed on traditional tax shelters and the limiting of itemized deductions" by the Tax Reform Act of 1986, and indicates that the features of single premium life "make for an attractive alternative to certificates of deposit and money market holdings." Indeed, single premium life appears to be popular on the investment market. LIMRA reports that 52 percent of single premium sales during 1986 was attributable to stockbrokers. The remainder was sold by career agents that worked for one particular insurance company, or insurance brokers that sold for one or more companies.

From a buyer standpoint, single premium life policies appear to be geared toward individuals at higher income levels. A LIMRA buyer study for 1985 showed that, for adult buyers of 237 single premium policies, the average premium was $31,000 for an $82,000 death benefit. In contrast, the average buyer of periodic-pay ordinary life paid an annual premium of $548 for a $58,840 death benefit. LIMRA also profiled the typical buyer as a professional or executive over the age of 50, with 57 percent of the buyers 50 or over. In terms of income, 18 percent of LIMRA's buyers had annual employment income of $75,000 or more, 26 percent earned between $25,000 and $75,000, 25 percent made less than $25,000 and 31 percent had no employment income.

CONCLUSIONS AND RECOMMENDATION

The features of single premium life insurance seem inconsistent with congressional efforts to constrain tax advantages for investment-oriented life insurance products. First, single premium life policies require large initial premiums, thus favoring individuals with sufficient wealth to be able to afford these sums. Income on the premiums is then not subject to taxation. Second, by offering low- or no-cost loans, the policies provide policyholders the opportunity to capture investment income without reflecting it on a tax return. Loans also erode death benefits and, if not repaid before the death of the insured, defeat the primary purpose of life insurance. Finally, distributions from single premium life insurance policies tend to be similar to distributions from deferred annuities, which are taxed. Accordingly, we recommend that Congress consider legislative remedies that would eliminate the tax advantage associated with investment-oriented single premium life insurance products.

Should Congress decide to change the tax status of single premium life insurance, we present two alternatives. One alternative would treat loans from single premium life insurance policies in the same manner as distributions from annuity contracts. Thus, loans from a policy would be considered as drawn from income first, and would be taxable income in the year withdrawn. The other alternative would change the definition of life insurance such that single premium contracts no longer qualify for favorable tax treatment if policy loans reduce the death benefit below certain levels already defined by law.

Although the first alternative is relatively clear-cut, the second may require further explanation. The corridor test under Section 7702 of the Internal Revenue Code disqualifies for tax-favored status any contract that allows excessive accumulation or build-up of cash value relative to the amount of life insurance provided. In effect, the death benefit must exceed the cash value by a specific percentage that decreases as the age of the insured increases.

Attachment I illustrates an actual fixed rate single premium life policy offered to a 55-year-old male. The premium on this policy is $50,000 for a $121,978 initial death benefit, and the declared interest rate at the time of purchase is 8.75 percent. Loans are provided after the first policy year at a cost of 8 percent and the policyholder is credited the same 8 percent on borrowed funds. The illustration assumes that interest rates will remain the same over the life of the policy and that, *beginning with the* second policy year, the policyholder borrows all the interest earned, or $4,375, at the beginning of each new year.

Attachment II illustrates the effect on the policy's death benefits if the policyholder borrows the full amount earned in the preceding year. As the table shows, the death benefit is depleted as the loan amount accumulates. However, for purposes of applying the corridor test under section 7702 of the Code, loans are not considered. Thus, even though the policy appears to have an increasing death benefit, the beneficiary would not realize the full amount if loans were outstanding.

Attachment III illustrates the effect of borrowing if the definition were changed to consider loans when computing death benefits under the corridor test. Basically, the table shows that the policyholder could take loans during the early policy years but would have to repay them shortly thereafter in order to maintain the policy's tax-favored status. If the loans were not paid back, the policy would no longer qualify as life insurance for tax purposes and the product would become a taxable investment account.

This concludes my prepared statement. We would be pleased to respond to any questions.

Attachment I

Attachment I

Single Premium Life Policy Illustration

Male Age 55, Premium - $50,000
Initial Death Benefit - $121,978
Current Accumulation Rate - 8.75%

Year	Accumulated Account Value	New loan at Beg. of Year	Cum. Loan at End of Year[a]	Death Benefit
1	$54,375	$0	$0	$121,978
2	59,100	4,375	$4,725	121,978
5	75,666	4,375	21,291	121,978
10	113,379	4,375	59,004	138,322
15	168,791	4,375	114,416	195,797
20	250,209	4,375	195,834	267,724

[a] Cumulative with interest at 8%.

Source: Data used in the preparation of this table obtained from actual policy illustration.

Attachment II Attachment II

Sample Single Premium Life Policy With Borrowing

Male Age 55, Premium - $50,000
Initial Death Benefit - $121,978
Current Accumulation Rate - 8.75%

			Ratio of Death Ben. to Accum. Acct. Val.		
Year	Death Benefit	Death Ben. After Loan	Actual	Minus Loan	Stat. Min.
1	$121,978	$121,978	224%	224%	150%
2	121,978	117,253	206	198	146
5	121,978	100,687	161	133	134
10	138,322	79,318	122	70	122
15	195,797	81,381	116	48	116
20	267,724	71,890	107	29	107

[a] Cumulative with interest at 8%.

Source: Data used in the preparation of this table obtained from actual policy illustration and Section 7702(d)(2) of the Internal Revenue Code.

Attachment III

Attachment III

Effect of Borrowing if Definitional Changes Were Adopted

Male Age 55, Premium - $50,000
Initial Death Benefit - $121,978

Year	New loan at beginning of year	Cumulative loan at end of year[a]	Death benefit after loan	Ratio of death benefit after loan to accumulated account value	Statutory minimum percent
1	$ 0	$ 0	$121,978	224%	150
2	4,375	4,725	117,253	198%	146
5	3,715	20,578	101,400	134%	134
6	(6,565)	15,134	106,844	130%	130
7	(8,059)	7,641	114,337	128%	128
8	(7,641)	0	121,978	126%	126
9	0	0	130,995	124%	124
20	0	0	284,405	107%	107

[a] Cumulative with interest at 8%.

Source: Data used in the preparation of this table obtained from actual policy illustration and Section 7702(d)(2) of the Internal Revenue Code.

GAO Tax Policy

TAXATION OF SINGLE PREMIUM LIFE INSURANCE

GAO

Deficit Reduction Act of 1984

Congress adopted a definition of life insurance out of concern over the proliferation of investment-oriented life insurance products.

GAO

Section 7702 of the Internal Revenue Code

Defines life insurance as any contract that meets either of two tests:

- The Cash Value Accumulation Test.
- The Guideline Premium/Cash Value Corridor Test.

Cash Value Accumulation Test

The cash value may never exceed the net single premium needed to pay all future benefits.

GAO

Guideline Premium/Cash Value Corridor Test

- Premiums cannot exceed guideline levels.
- Death benefits cannot be less than a percentage of the cash value.

GAO

Tax Benefits Associated With All Life Insurance

- Earnings accumulate tax-free.
- Proceeds not taxed if paid to the beneficiary upon death of the insured.
- Policy loans on earnings not subject to taxation.

GAO

Tax & Investment Benefits of Single Premium Life

- Designed to qualify as life insurance under the law.
- Policyholders enjoy all tax benefits of life insurance.

GAO

Tax & Investment Benefits of Single Premium Life

One large, single premium is paid up-front.

- More funds are immediately available to invest.
- Inside build-up occurs more rapidly.

GAO

Characteristics of Single Premium Life Insurance

Types of products:

- Fixed rate policies
- Variable rate policies

GAO

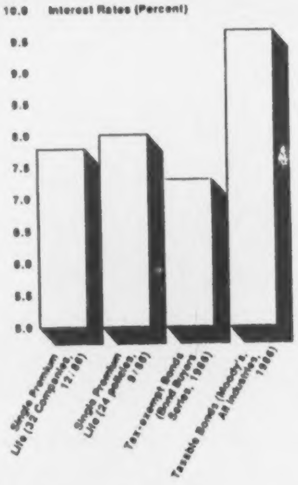
Characteristics of Single Premium Life Insurance

Numerous companies offer single premium products that provide

- market sensitive, competitive rates of return;

- low cost or no-cost loans against accrued interest.

GAO Interest Rate Comparison: Fixed Rate Policies and Bonds (1986)



Source: Data used in this graph obtained from LIMRA, A.M. Best, and the Federal Reserve Bulletin

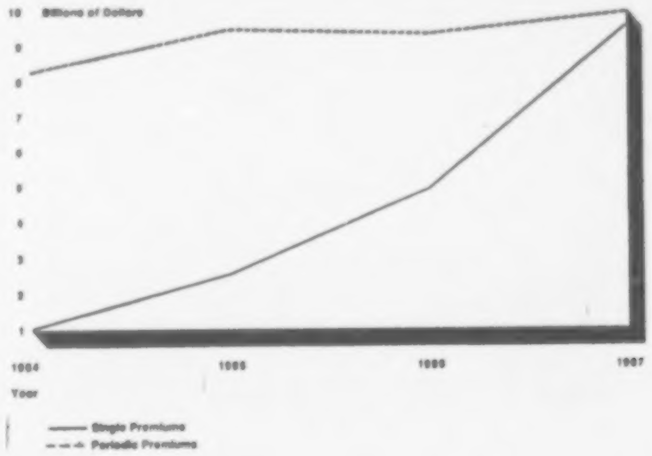
GAO

Characteristics of Single Premium Life: Policy Loans

Many policies offer 0 net-cost or "wash loans" on earnings.

- Interest paid on amount of loan is the same as rate charged to borrow.
- Policy loans usually become available after first policy year.

GAO Growth of Single and Periodic Premium Sales (1984 to 1987)



Source: Data used in the preparation of this graph obtained from LIMRA.

GAO Sales of Single Premium Life Insurance Products

Industry researchers attribute dramatic growth to

- attractive features;
- loss of traditional tax-shelters.

GAO

Sales of Single Premium Life Insurance Products

LIMRA data on percent of single premiums sold by type of distributor during 1986.

- Stockbrokers - 52%
- Career Agents - 31%
- Insurance Brokers - 17%

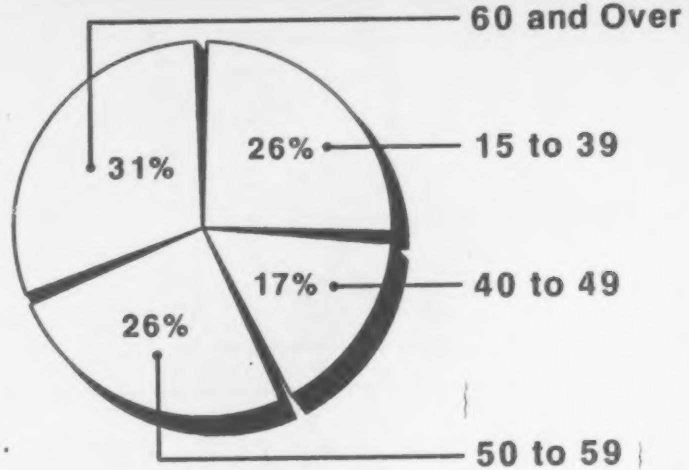
GAO

LIMRA'S Buyer Study for 1985

- Adult buyers of 237 single premium policies paid an average premium of $31,000 on an $82,000 death benefit.

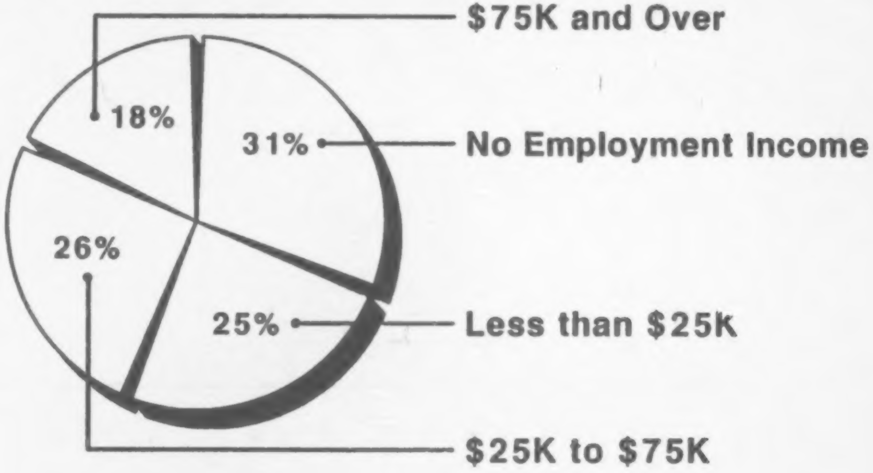
- Buyers of all periodic-pay ordinary life paid an average annual premium of $548 on a $58,840 death benefit.

GAO Percent of Policies Sold by Age Group (237 Policies Sold in 1985)



Source: Data used in the preparation of this graph obtained from LIMRA.

GAO Percent of Policies Sold by Employment Income (237 Policies Sold in 1985)



Source: Data used in the preparation of this graph obtained from LIMRA.

GAO Tax Policy Issues

The features of single premium life insurance may be inconsistent with congressional efforts pertaining to life insurance and investments.

GAO Tax Policy Issues

- Products are geared toward individuals at higher income levels and provide opportunities for tax-sheltering.
- Low or no-cost loans allow policyholders to capture investment income without reflecting it on a tax return.

GAO Recommendation

Consider legislative remedies that would eliminate the unintended tax advantage associated with investment-oriented single premium life insurance products.

GAO

Approaches Available to the Congress

Under the first approach loans or distributions on earnings would be taxed as income in the year withdrawn.

GAO

Approaches Available to the Congress

The second approach would remove favorable tax treatment on policies if loans reduced death benefits below levels already defined by the corridor test.

GAO Male Age 55, Premium $50,000, Current Accum Rate 8.75%

Year	Accumulated account value	New loan at beg. of year	Cum. loan at end of year[a]	Death benefit
1	$54,375	$0	$0	$121,978
2	59,100	4,375	$4,725	121,978
5	75,666	4,375	21,291	121,978
10	113,379	4,375	59,004	138,322
15	168,791	4,375	114,416	195,797
20	250,209	4,375	195,834	267,724

[a] Cumulative with interest.

GAO

Male Age 55, Premium $50,000, Current Accum Rate 8.75%

Year	Death benefit	Death ben. after loan	Ratio of death ben. to accum. acct. val.: Actual	Ratio of death ben. to accum. acct. val.: Minus loan	Ratio of death ben. to accum. acct. val.: Stat. min.
1	$121,978	$121,978	224%	224%	150%
2	121,978	117,253	206	198	146
5	121,978	100,687	161	133	134
10	138,322	79,318	122	70	122
20	267,724	71,890	107	29	107

GAO Male Age 55, Premium $50,000, Initial Death Benefit $121,978

Year	New loan at beginning of year	Cumulative loan at end of year	Death benefit after loan	Ratio of death benefit / account value	Statutory minimum percent
1	$0	$0	$121,978	224%	150
2	4,375	4,725	117,253	198	146
5	3,715	20,578	101,400	134	134
6	(6,565)	15,134	106,844	130	130
7	(8,059)	7,641	114,337	128	128
8	(7,641)	0	121,978	126	126
9	0	0	130,995	124	124

Chairman **Rangel.** Thank you.

Any members seeking recognition?

Mr. **Stark.** Yes.

Chairman **Rangel.** Mr. Stark.

Mr. **Stark.** Mr. Chairman, I want to thank the GAO for their testimony and hard work. They have worked on this question. They worked with us years ago. We did the revision of life insurance taxation, and they are to be commended, Ms. Stathis has done an excellent job, and Dr. Gandhi we rely on and impose on a lot.

Yesterday, we talked some about the definitional question, and it seems to me I can figure out a way we can gain your suggestion—I have forgotten how we figured out that we had to tighten it up.

What was the loophole?

Mr. **Gandhi.** I don't think there was a loophole, sir.

Mr. **Stark.** I will have to go back and look at it and see. It seemed to me that advanced ages, where there is almost no insurance, wasn't that where we figured it?

Mr. **Gandhi.** Right. Also, there is a problem in advanced ages, you may bump into the ceiling there. That is a problem that we need to address.

Mr. **Stark.** For somebody pretty close to 65, where the insurance portion disappeared, they are buying a big mutual fund contract, and this definition doesn't take care of that, correct?

Mr. **Gandhi.** Yes, sir. I want to add this much, sir. That, you know, this particular proposal does preserve the loan feature as it exists in traditional life insurance.

Mr. **Stark.** I understand. Thank you very much.

Thank you, Mr. Chairman.

Chairman **Rangel.** Mrs. Kennelly.

Mrs. **Kennelly.** Thank you, Mr. Chairman.

Soon, Mr. Gandhi, we are going to hear testimony from the NALU Association. They have identified the problem as a single problem, as you have. If you are familiar with it while you are testifying before us, can you discuss the difference with your approach with the NALU approach?

Mr. **Gandhi.** In the case of the NALU approach, there would not be single premium life as we generally know. No one premium would be more than 20 percent of the overall policy value. Under our approach, you could still have the single premium policy.

A problem would arise in our approach only when the investment orientation of the policy is quite evident, and the policyholders starts to seek the loan, without the intent to repay thus violating our test. Under the NALU approach, there would not be any single premium as we currently know it.

Mrs. **Kennelly.** There is that much difference in the definition and the other approach.

Mr. **Gandhi.** Right.

Mrs. **Kennelly.** I came in a little late, so I would like to get your answer to this question: In your research which I know has been extensive, have you found any indications there is widespread purchasing of whole life policies or universal life policies for investment purposes or, Mr. Gandhi, is your bottom line that this is a problem of the single premium policies?

Mr. Gandhi. The single premium policies, in general have grown the most over the last year. The extent to which the policies have a substantial amount of investment orientation is difficult to fathom because we do not know the motives of the policyholder.

However, looking at the statistics on the various policies, it would be reasonable to assume that they are primarily investment-oriented instruments rather than life insurance policies.

Ms. Stathis. Mrs. Kennelly, I think also adding to that, our study encompassed only single premium policies. We did not look at other types of life insurance policies in this particular study. So, I think it is fair to say, you know, we don't know whether there is a significant investment orientation in some of those as well.

Mrs. Kennelly. Thank you, Ms. Stathis. You obviously do favor the definitional approach. Let me ask you something, Mr. Gandhi.

Do you think it might be wise to take some of the changes that the Stark-Gradison legislation suggests and apply them to single premium, so people might be less willing to buy the single premium for investment and be more willing to buy it as a large insurance product?

Ms. Stathis. I think that is essentially the first alternative that we present in our statement.

Mrs. Kennelly. Okay. Thank you very much.

Thank you, Mr. Chairman.

Chairman Rangel. Let me thank the General Accounting Office for doing the superb job that Congress has come to rely on it for. I will ask you whether or not you have studied in singling out premium insurance policies, the potential problem of administration of different policies by the industry, do you see any unique problems in your approaches to this?

Ms. Stathis. I don't think that was part of our study. Are you saying there would be administrative problems if one of those alternatives were to be taken, none that I know of.

Chairman Rangel. Yes?

Mr. Gandhi. In case of the monitoring of the loan, I think the insurance companies do that on a regular basis so we don't anticipate any of the administrative problems that are usually talked about.

Chairman Rangel. Well, let me thank you very much for the contribution you have made over the years. We will be coming back to you before markup.

Mr. Gandhi. Thank you, sir.

Chairman Rangel. Now we will go into the panel mode of the hearings. The first panel will be Andrew Pike, associate professor of law, American University; a former colleague from the Senate, Richard Schweiker, president, American Council of Life Insurance, and former Secretary of Health and Human Services; Hon. Bill Irons, Federal Law and Legislation Committee, and State senator from Rhode Island, who will be accompanied by William V. Regan III, CLU, member, Task Force on Product Taxation.

The Chair thanks the witnesses for adjusting their schedules in order to share their views with us. We regret, as you all know, that we are limited to the 5-minute rule. But as all of you know, your entire testimony, if there is no objection from the committee, will be entered into the record.

And so, you can proceed as you find most comfortable in highlighting your testimony so that the committee members would have the opportunity within the time restraints to ask additional questions. We will start with Professor Pike.

STATEMENT OF ANDREW D. PIKE, ASSOCIATE PROFESSOR OF LAW, AMERICAN UNIVERSITY, WASHINGTON COLLEGE OF LAW

Mr. **Pike**. Thank you, Mr. Chairman.

I have heard many comments today asking whether the balance that is achieved between investment and insurance in section 7702 makes sense. What is the problem? Why are we revisiting this question after only 4 years?

Three things have changed since 1984. First, Congress enacted the 1986 Tax Act in which it eliminated many tax-sheltered investments. As Congressman Stark said earlier, life insurance is one of the few games left in town.

Second, the increased sales and advertising of single premium life insurance policies has attracted attention. That is another reason to look at this issue once again. Third, what I would like to focus on, is that some of the decisions reflected in section 7702 may not be wise, and perhaps should be revised.

Congressman Flippo earlier asked how do you decide how much cash value is too much, and how much life insurance should be needed?

I would propose that the tax exemption of interest credited to cash value life insurance policies is based on the notion that you want to encourage certain behavior. You want to encourage people to buy more insurance for their families. Is that a desirable social goal? I think it is.

Should it be encouraged? I think it should. Does the tax treatment of cash value life insurance promote the purchase of additional insurance protection in a sensible way? Particularly for contracts like single premium and other investment-oriented contracts, I think the answer is clearly not.

How does cash value life insurance encourage people to behave? Does it encourage people to get more insurance protection for their family or less? Does the existence of the single premium contracts encourage people to buy more insurance or less? In many instances, people are encouraged to purchase less insurance protection.

That sounds crazy to me. Many of the examples in the written statements consider a taxpayer aged 55. I think that the more appropriate model is a taxpayer aged 35 who has young children and who is concerned about replacing their salary income if they were to die.

How does the existing law encourage this 35-year-old person to behave? If they owned term insurance the current tax treatment of life insurance, encourages a switch to a level premium contract. Alternatively, if they owned a level premium contract, they might move towards a single premium contract, because the tax benefits are greater.

Assume that our model 35-year-old could afford to pay $1,000 for life insurance protection. How much insurance could this $1,000 buy? For a level premium contract, the debt benefit might be $100,000. For a single premium contract, it would be far smaller; it might be $10,000 or less. If an individual switches, as a result of the incentives created in the tax law, from a level premium to a single premium contract, and if that individual were to die, his family would be much worse off.

Is that a sensible way to encourage people to behave? I think not. If you want to encourage people to buy more insurance protection for their family through the tax law, the way to do it is to target the benefits to the cost of insurance protection.

Under a single premium contract issued to an individual 35 years of age, the interest created might be seven or eight times as much as the cost of insurance protection provided during any year. The tax revenue foregone as a result of not taxing this interest is greater than it would cost for the Government to buy term insurance for the insured.

In this regard, I agree with one aspect of the NALU proposal. I think that a change in the definition would be sensible. The definition of life insurance should limit the preferential tax benefits to life insurance contracts that fairly approximate a contract under which the interest credited is commensurate with the cost of insurance protection provided in just about every year.

I don't think the single premium contract does that. I think something modeled on a level premium contract makes sense.

Finally, I would say that when somebody takes money out of a life insurance contract, that money is no longer used to provide insurance protection or to save for retirement. It is spent. It is not like a loan that has to be repaid. Most life insurance policy loans do not require repayment, except out of the cash value of the policy. The company knows that that money need never be repaid. The policyholder knows it. It should be treated like other forms of income that are taxed no later than when it is spent.

Thank you. I would be happy to answer questions now or after the other gentlemen speak.

Chairman RANGEL. Thank you.

[The statement of Mr. Pike follows:]

STATEMENT OF ANDREW D. PIKE
ASSOCIATE PROFESSOR OF LAW
WASHINGTON COLLEGE OF LAW, THE AMERICAN UNIVERSITY
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS OF THE
HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present my views on the tax treatment of life insurance contracts. My testimony will focus on the following general questions:

- Does the definition of life insurance enacted in 1984 establish appropriate limits on the investment orientation of life insurance contracts?

- Would a more reasonable balance between the investment and life insurance features be achieved by changing either (1) the definition of life insurance or (2) the taxation of pre-death distributions or policy loans?

Investments in the form of cash value life insurance receive preferential treatment under the income tax laws in three significant respects. First, the taxation of interest credited is deferred. Second, the income measurement rules cause a portion of the interest credited to escape taxation. Third, section 101(a) generally excludes the remaining interest from income if the policy remains in force until the death of the insured.

The statutory definition of life insurance contained in section 7702 was a response to the marketing of "investment-oriented products" that maximized these tax advantages. Section 7702 generally denies the tax benefits of life insurance to contracts more investment-oriented than a single premium life insurance contract.

Notwithstanding the enactment of this statutory definition, debate concerning the proper tax treatment of life insurance investments continues. In 1986, Congress eliminated numerous tax preferences and enacted limitations applicable to most other tax-sheltered investments. This led many financial analysts and writers to focus increased attention on life insurance. The life insurance industry capitalized on these developments by advertising the tax benefits of the single premium life insurance contracts. Taxpayers seeking to avoid the limitations on tax shelters, IRAs, 401(k) plans, Clifford trusts or the kiddie tax are advised that unsurpassed tax benefits are available to owners of single premium contracts.

I. THE ECONOMIC COMPONENTS OF LIFE INSURANCE CONTRACTS

To determine whether overly investment oriented uses of life insurance receive preferential tax treatment, it is first necessary to understand the economic components of a life insurance contract. Frequently, an individual is concerned that her death, and the loss of her salary, may leave her family with inadequate financial resources to maintain an acceptable standard of living. Through the purchase of life insurance, an individual shifts this financial risk to a life insurance company. If the insured dies during the period that the contract is in effect, the insured's beneficiaries receive a specified dollar amount called the death benefit. Following the insured's death, investment of the death benefit will generate income that replaces a portion of the insured's salary.

Term Life Insurance: Term life insurance provides insurance protection for a limited time period. As with all forms of life insurance, the insurance company pays the specified death benefit if the insured dies during the period of coverage. If the insured survives until the end of the period of coverage, however, the insured and the designated beneficiaries have no further economic claims against the life insurance company.

The premium charged for a term policy is based primarily on the probability of the insured's death during the period of coverage. In most instances, the premium charged represents a small percentage of the death benefit because the likelihood that an individual will die during a particular year is relatively small.1/ The linkage between the probability of the insured's death and the premium charged causes term insurance premiums to increase as the age of the insured increases.

Cash Value Life Insurance: The second major type of life insurance is "cash value" life insurance.2/ In addition to paying the specified death benefit upon the insured's death, this type of policy creates a cash value during the insured's life. The cash value is the amount that the policyholder is entitled to receive if the policy is canceled.

The prototypical form of cash value life insurance is level premium "whole" life insurance. In this type of contract, a fixed premium is charged annually for the remainder of the insured's life. The premium remains constant notwithstanding the increasing likelihood of the insured's mortality. During the initial years of the contract, the premium paid exceeds the cost of current insurance protection provided. The excess of the premium over the cost of current insurance protection, together with investment income credited thereto, generates a fund that serves two purposes. First, the fund may be used to pay benefits under the contract in later years. Second, the balance in ~~the~~ fund serves as the basis for computing the cash value of the policy.

To illustrate the generation of cash value under a level-premium contract, consider a hypothetical contract with a death benefit of $100,000 issued to a 35 year old individual. The annual premium for this contract is $1,306.3/ As illustrated in Appendix Table 1, this premium first is applied to pay the cost of current insurance protection, which is $211. The remaining $1,095 is added to the policy "fund" where it is credited with interest at a four percent rate. During this first year, this interest totals $44. At the end of this year, the cash value is $1,139. The amount of interest credited is commonly called "the inside interest build-up" of a life insurance policy.

The payment of the annual premium in the second (and subsequent) year increases the cash value. As in the first year, the charge for the current insurance protection reduces the cash value. The amount of current insurance protection provided under the contract is no longer the full $100,000 death benefit. The cash value of $1,139 reduces the insurance protection to $98,861. Consequently, the mortality (or term insurance) charge imposed for life insurance protection under the contract is based on the net amount at risk of $98,861. During subsequent years, the cash value of the policy increases, and the amount of current insurance protection declines.

Examination of a $100,000 single premium life insurance contract issued to a 35 year old illustrates the complex interaction among the economic components of cash value life insurance. The single premium for this contract is $25,408; no additional premiums

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1. According to the 1980 Commissioners' Standard Ordinary Mortality Table, the likelihood that a 50 year old will die during the next year is less than one percent.

2. Cash value life insurance includes "whole" life insurance, single premium life insurance, universal life insurance and variable life insurance.

3. The premium in the example reflects a four percent assumed interest rate and mortality charges based on the 1980 Commissioners' Standard Mortality Table. To simplify the discussion, the premium does not reflect other charges imposed under the life insurance contract.

are payable. The death benefit remains at $100,000. In each year, the single premium contract generates higher levels of cash value and credits more interest than the level-premium contract discussed previously. See Appendix, Table 2. The larger cash values reduce the amount of current insurance protection, thereby reducing the cost of current insurance protection.

The principal economic differences between the level premium contract and the single premium contract during the first year are illustrated as follows:

		Level Premium Contract	Single Premium Contract
Yr 1:	Premium	$1,306	$25,408
	- Cost of Current Ins. Protection	(211)	(211)
	+ Interest Earned	44	1,008
	= Closing Cash Value	1,139	26,205
Yr 2:	Term Insurance Protection	98,861	73,795

II. CURRENT TAX TREATMENT OF THE POLICYHOLDER

As discussed above, the tax treatment of the investment income credited to the cash value of life insurance contracts differs from the tax treatment of other forms of interest in three significant respects. First, the taxation of the interest is deferred. Second, the income measurement rules cause a portion of the interest credited to escape taxation. Third, section 101(a) generally excludes the remaining interest from income if the policy remains in force until the death of the insured. Each of these tax benefits is discussed below.

The Tax Deferral Benefits: A primary tax benefit resulting from the ownership of cash value life insurance relates to the timing of taxation: as long as the cash value accumulates, no portion of the interest credited to the cash value is included in income. Further deferral results from the operation of the "ordering rules" applicable to withdrawals from life insurance contracts. See I.R.C. § 72(e). These ordering rules characterize cash distributions from life insurance contracts either as non-taxable returns of the policyholder's investment or as taxable interest credited. Under the life insurance ordering rules, cash withdrawn from the contract is excluded from income until the aggregate amount received exceeds the policyholder's investment in the contract. I.R.C. §§ 72(e)(5)(A), (C). As a result, taxation of the interest credited under a cash value life insurance contract is deferred until the policyholder withdraws a substantial portion of the cash value.

The period of deferral is further extended if the cash withdrawals are in the form of policy loans. Loans secured by a life insurance contract are not treated as distributions for tax purposes. Although interest is payable on most policy loans, the policyholder's pre-tax cost of borrowing is minimal because the interest payable on the loan is largely offset by the interest credited to the cash value. If the interest paid on the policy loan is deductible, borrowing may produce an after-tax profit for the policyholder.4/ Consequently, use of policy loans enables the

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4. Several provisions may cause the interest paid on policy loans to be disallowed. For non-corporate policyholders, the deduction for interest paid is subject to the general limitations imposed on investment interest and personal interest. See I.R.C. §§

policyholder to extend the period of tax deferral at little cost. The combined effect of the income deferral allowed under section 72(e) and the treatment of policy loans is that the interest credited under cash value life insurance escapes taxation until the policy terminates.

Understatement of Income: Owners of cash value life insurance enjoy a second lifetime tax benefit: taxable income, when realized, systematically understates the amount of interest income credited under the policy. The charges for term insurance protection (and any other charges imposed) are subtracted from the interest credited in computing the cash value. If a policyholder surrenders a contract, the amount includible in income is limited to the excess of the amount received (i.e., the cash value of the policy) over the investment in the contract. The amount of interest credited under the contract exceeds the amount included in the policyholder's income by the cumulative amount of term insurance costs and other charges. In effect, the policyholder is allowed to deduct the cost of current insurance protection. This cost otherwise would be a non-deductible personal expense of the policyholder.

Forgiveness of Tax Upon the Death of the Insured: The third tax benefit accorded owners of cash value life insurance is that the interest income not taxed previously is exempted from taxation upon the death of the insured. The death benefit consists of both the contract's cash value as of the insured's death, and the current insurance protection provided under the contract. In general, amounts payable on account of the insured's death, including that portion representing the accumulated untaxed interest, are excluded from income. I.R.C. § 101(a)(1).

III. TAX POLICY ANALYSIS OF POLICYHOLDER TAX TREATMENT AND SECTION 7702's GENERAL LIMITATIONS

In evaluating whether the existing tax treatment of investments made in the form of cash value life insurance is justified, the following tax policy questions should be considered:

- What tax policy concerns justify the current tax treatment of interest credited under cash value life insurance?
- Does section 7702 establish appropriate limits on the range of life insurance contracts that qualify for preferential tax treatment?

These questions are discussed below.

A. What Tax Policy Concerns Justify the Current Tax Treatment of Cash Value Life Insurance?

The most frequently cited justification for the preferential tax treatment of cash value life insurance is that an incentive is needed to encourage taxpayers to provide for their families' financial security. Protecting one's family against financial adversity is a laudable goal. The existence of this objective, however, does not necessarily justify the existing preferential tax treatment. In addition to showing that a worthwhile objective is advanced, two further criteria must be satisfied. First, the favorable tax treatment must induce changes in taxpayer behavior that significantly advance the perceived social goal. Second, the behavior likely to be changed must be sufficiently important to justify the revenue loss. Neither criterion is satisfied.

The preferential tax treatment of investment income earned under a cash value life insurance contract is likely to induce taxpayers to invest more resources in this financial product. How does the purchase of cash value life insurance protect an individual

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163(d) and (h). Although additional limitations apply to interest paid on loans related to certain life insurance contracts, I.R.C. §§ 264(a)(2)-(4), taxpayers frequently can avoid these limitations.

against financial adversity? Cash value life insurance can enhance an individual's financial security by protecting against the loss of two distinct income streams. First, the contract's death benefit provides a source of funds to replace the insured's salary if the insured were to die prior to retirement. Second, the cash value provides a source of funds that replaces a taxpayer's salary following retirement.

Life Insurance as a Source of Post-death Income Replacement: The unique insurance function that life insurance serves relates primarily to the replacement of the insured's income following the insured's death. Frequently, a parent is concerned that the loss of her income would leave her dependents without adequate means of support.

An individual's income consists of both investment income and compensation for the performance of services. Ownership of cash value life insurance can increase the resources available to replace both sources of income. First, the buildup of the contract's cash value increases the individual's wealth. This increased wealth will be available to generate post-death investment income for an insured's dependents that will replace the investment income earned by the insured during her lifetime. Savings in the form of a life insurance contract's cash value, however, does not differ from other forms of savings in this regard. Consequently, preferential tax treatment to induce this behavior is not justified.

The portion of the death benefit that consists of term insurance protection provides a fund that generates income to replace the insured's salary. The existence of this type of fund enhances the financial security of the insured's family. Unfortunately, the existing tax benefits contain a perverse set of incentives that are likely to induce undesirable changes in taxpayer behavior. To the extent that the tax law induces a switch from term insurance to cash value life insurance, the taxpayer is likely to obtain less insurance protection. The premium charged for a level premium cash value life insurance contract is much larger than the initial premium for a term contract with an identical death benefit.5/ Unless the taxpayer greatly increases the portion of her budget allocated to life insurance, the amount of insurance protection will decline. If a taxpayer increases the purchase of cash value life insurance, the likely effect is that individuals will decrease their insurance protection.

Paradoxically, the current tax treatment also provides the greatest tax benefit to taxpayers whose insurance needs are modest, and no benefit to those with much greater needs. The tax benefits of cash value life insurance are available only to taxpayers who can afford to obtain their current insurance protection in conjunction with a savings program. The greatest tax benefits are received by taxpayers with substantial wealth who can afford to purchase large amounts of single premium insurance. Yet the accumulated wealth of these taxpayers makes it more likely that their families could maintain their standard of living without life insurance protection.

Less, if any, incentive is provided, however, for taxpayers with little wealth. For taxpayers who can afford to purchase a level premium cash value contract, the tax benefits are less substantial. For taxpayers who cannot afford to pay the higher premiums charged under a cash value contract, financial protection is affordable only in the form of term life insurance. The cost of term insurance, however, generally is not deductible. Because of the irrational relation between the need for insurance protection and the distribution of tax benefits, the existing tax treatment's incentive to provide financial security should receive a low budgetary priority.

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5. Although term insurance premiums increase as the insured ages, the annual cost of term insurance generally will not exceed the level premium for the cash value contract for many years.

Life Insurance as a Source of Retirement Income: Cash value life insurance purportedly enhances an individual's financial security by providing a source of post-retirement income. The perceived need to encourage savings for retirement also underlies the preferential tax treatment given to qualified pension plans and individual retirement accounts. The possible use of a life insurance contract's cash value as a source of post-retirement income, however, does not justify the current tax treatment. Favorable tax treatment is not granted to all forms of savings that may, in fact, be used to provide post-retirement funds.

The tax benefits available to participants under qualified pension plans are provided as a "carrot" to encourage employers to provide for the retirement security of low and moderate-income workers. It is unlikely that large amounts set aside for retirement would receive such favorable tax treatment if qualified pension plans provided benefits only for the plan sponsor's owners and senior executives.

The tax treatment of individual retirement accounts also suggests that Congress is willing to provide only limited tax incentives to encourage individuals to save for their own retirement. The Tax Reform Act of 1986 enacted substantial limitations that apply to IRAs: the annual contribution cannot exceed $2,000; and many taxpayers who are covered by a pension plan cannot deduct contributions to these accounts. These limitations indicate that the possible use of a life insurance contract's cash value as a source of post-retirement income does not justify the current tax treatment of cash value life insurance.

Deferred annuities are also taxed in a preferential fashion: interest income credited under deferred annuities is not taxed currently. The tax treatment of deferred annuities, however, provides a weak basis for retaining the current tax treatment of cash value life insurance. First, in 1986 Congress concluded that encouraging long-term or retirement savings was no longer a sufficient justification for allowing pension plan participants to invest in tax-deductible IRAs. This conclusion is incompatible with the justification Congress stated in 1982 for retaining the preferential tax treatment of deferred annuities, i.e., that they furthered "long-term investment and retirement goals." Second, annuities are subject to numerous provisions designed to make sure that the savings are used for retirement. For example, cash withdrawals and loans from annuity contracts are treated first as taxable distributions and, in certain instances, are subject to a penalty tax. Life insurance contracts are not subject to comparable provisions.

In conclusion, tax policy concerns do not justify the current tax treatment of cash value life insurance for three reasons. First, current law creates a perverse set of incentives that may actually lead to a reduction of financial security. Second, the tax incentives apply in an upside-down manner: the greatest benefit is made available to wealthy taxpayers who have the least need for insurance protection; and the smallest benefit is provided to those whose insurance needs are greatest. Third, in terms of providing post-retirement income security, a life insurance contract's cash value is indistinguishable from many other forms of taxable savings. It should be noted, however, that narrowing the definition of life insurance and changing the tax treatment of withdrawals from life insurance contracts would reduce the seriousness of these shortcomings.

B. Does Section 7702 Establish Reasonable Limits on the Range of Life Insurance Contracts That Qualify For Preferential Tax Treatment?

During the early 1980s, life insurance companies marketed new life insurance contracts that provided de minimis amounts of current insurance protection. A definition of "life insurance" was sought that would deny life insurance status to overly investment oriented life insurance products without affecting most life insurance product designs marketed prior to the 1980s. To achieve this result, section 7702 uses the single premium contract serves as the model of acceptable investment orientation. The threshold question in evaluating section 7702 is whether the tax-free investment income generated under a single premium contract is excessive. If the single premium model allows excessive amounts of investment income, the balance between the investment and insurance components of life insurance in section 7702 should be revised.

The most plausible justification for life insurance's preferential tax treatment is that it encourages individuals to provide a source of funds to replace their salary in the event of their death. If the tax benefits are disproportionate relative to the cost of insurance protection provided, section 7702 permits an excessive degree of investment orientation.

Examination of the single premium contract discussed in Part I illustrates the investment orientation of a single premium life insurance contract. Assuming that interest is credited at a rate of only four percent, the interest credited in each of the first 35 years is more than twice the level of the charges imposed for term insurance protection. During each of the first twenty years, more than three dollars of interest is credited for each dollar charged for term insurance protection.

If interest were credited at rates closer to market interest rates, the relative amounts of interest credited, compared to the charges for term insurance protection, would be even greater. For example, if interest is credited at an eight percent rate, during each of the first twenty years more than six dollars of interest will be credited for each dollar charged for term insurance protection; during the first fifteen years the ratio of interest credited to mortality charges will exceed 8:1.

In many instances, the tax revenue foregone due to the failure to tax the interest credited under a single premium policy exceeds the cost that the government would incur if it purchased the insurance protection and provided it to the policyholder without charge. Assuming that interest is credited at a rate of eight percent, at least $1.20 of tax revenue is foregone to provide term insurance protection that costs $1.00 for a taxpayer subject to the 15 percent tax rate. For a taxpayer subject to a tax rate of 28 percent, tax revenues of $3.36 are foregone to produce term insurance protection that costs $1.00. Even if interest is credited at only a four percent rate, for a taxpayer in the 28 percent marginal tax bracket the tax revenue foregone exceeds the cost of current insurance protection provided for more than fifteen years.

Under the single premium contract, the costs in terms of tax revenue foregone are clearly disproportionate to the social benefit of encouraging term insurance protection. The statutory definition of life insurance should require a more reasonable balance between the expected amount of interest credited and the cost of current insurance protection provided.

It is possible to create alternatives to the existing definition of life insurance that would target the tax incentives to the socially desirable goal. One possibility would be to allow interest credited under a life insurance contract to be excluded from gross income only to the extent that it is applied to pay for the costs of term insurance actually provided. Any additional interest credited would be taxed currently to the owner of the life insurance contract. The advantage to this proposal is that the tax preference is limited to amounts expended for the desired act, i.e., the purchase of life insurance protection.

Under a second (and somewhat more modest) alternative, the definition of life insurance contained in section 7702 would be amended. Instead of adopting the single premium contract as the limit of acceptable investment orientation, a model based on the level premium contract would be used. As was seen in connection with the level premium contract discussed in Part I, the interest credited bears a more reasonable relation to the cost of term insurance protection. Even under the single premium contract, the interest credited exceeds the cost of term insurance protection in each year after the contract has been in effect for six years.

IV. ANALYSIS OF THE TAX TREATMENT OF DISTRIBUTIONS AND LOANS FROM LIFE INSURANCE CONTRACTS

Under current law, the owner of a life insurance contract may receive substantial amounts of cash without including any amount in income. Cash distributions from a life insurance contract are excluded from gross income until the aggregate amount received exceeds the policyholder's investment in the contract. If cash is received as a policy loan, no amount is includible in the policyholder's income.

H.R. 3441 would conform the distribution rules applicable to life insurance contracts to the existing rules governing deferred annuities. These rules are similar to the provisions governing distributions from pension plans and IRAs. Under H.R. 3441: (1) pre-death distributions from a life insurance contract would be treated as taxable income to the extent of the income on the contract; (2) policy loans would be treated as pre-death distributions; and (3) a 10 percent penalty would be imposed on certain taxable distributions occuring before the taxpayer reaches age 59½. These proposed changes are sound, and should be enacted.

Interest credited under a cash value life insurance contract should be taxed no later than when the policyholder receives cash or another economic benefit under the contract. For most investments, the interest earned is taxed in the year when the interest is set aside or credited to the taxpayer's account. Interest credited under a life insurance contract is not taxed currently because the interest will be used either to pay for the cost of term insurance or to provide a source of post-retirement income. When cash is withdrawn from the life insurance contract, it becomes certain that the income will not be used for either of these purposes. Any justification for not taxing the interest income is eliminated.

The appropriateness of characterizing withdrawals as income first, rather than as a return of basis, is illustrated in the following example. Assume that: (1) a taxpayer purchases a life insurance contract for $10,000 on January 1, 1988; (2) the cash value of the contract on December 30, 1988 is $10,500; and (3) the taxpayer withdraws $500 on December 31, 1988 to spend on holiday cheer.

How should these events be analyzed? The taxpayer's net worth has not changed: she started and ended the year with an asset worth $10,000. During the year, the taxpayer's asset was credited with $500 worth of interest (in excess of the cost of term insurance) and $500 was spent for personal enjoyment. Two conclusions are appropriate. First, the taxpayer's investment of $10,000 remains undiminished. Second, the financial security of the taxpayer has not been enhanced. All that has happened is that income earned during the year was used for personal purposes. The tax system should conform to this reality and treat the distribution as income.

If the rules governing the characterization of distributions from life insurance contracts are changed, then policy loans should be characterized as distributions. In most instances, the policyholder is not obligated to repay the amount borrowed; the loan will be satisfied with either the contract's cash value or any death benefits payable to the contract's beneficiaries. As with the explicit withdrawal of cash, the borrowed amounts are no longer available to pay term insurance charges or to provide a source of retirement income. Again, any justification for the tax deferral ceases.

The tax treatment of distributions and loans from life insurance contracts cannot be reconciled with the treatment of other tax-deferred savings vehicles, such as deferred annuities, IRAs and qualified pension plans. There is no apparent justification for the unique treatment accorded distributions from a life insurance contract. These tax-preferred savings vehicles receive tax benefits to encourage savings. The justification for the favorable tax treatment terminates when the funds are used for unrelated purposes. As with the distributions from pension plans and individual retirement accounts, the continued deferral of taxation is no longer justified. Similarly, a tax penalty to reflect the economic benefit of tax deferral is equally appropriate in the case of distributions from life insurance contracts as with distributions from deferred annuities, IRAs and pension plans.

V. PROBLEMS WITH TECHNICAL PROVISIONS OF SECTION 7702

Inadequate Restrictions on Mortality and Expense Charges: Section 7702 uses an actuarial concept, i.e., the actuarial single premium, to establish the limit of acceptable investment orientation. Use of this actuarial standard is potentially subject to abuse through the use of questionable actuarial assumptions. Section 7702 limits the range of permissible actuarial assumptions to prevent life insurance companies from artificially inflating the investment orientation of contracts that satisfy the provision's requirements. Unfortunately, these limitations are inadequate. They should be tightened.

To maintain a meaningful balance between investment and term insurance protection, section 7702 prohibits the use of unduly low assumed interest rates. Unfortunately, section 7702 does not create effective limits on the maximum assumed mortality and expense charges. In the absence of effective limits on these charges, it is possible that investment oriented life insurance contracts will specify extremely high mortality charges.6/ The absence of explicit statutory limitations on the use of inflated mortality and expense charges constitutes a serious defect in section 7702.

The Adjustment Rules: The limitations contained in section 7702 are based on the contractual benefits specified when the contract is issued. The adjustment rules contained in section 7702(f)(7) are designed to adjust the limitations to changes in the contractual terms occurring subsequent to the issuance of the contract. Without effective adjustment rules, taxpayers could avoid the intended limitation on investment orientation of life insurance contracts.

Although a detailed discussion of these extraordin~~ar~~ily technical rules is beyond the scope of these hearings, the following shortcomings in these rules deserve attention:

- For contracts subject to the guideline premium limitation, an excessive amount of cash is allowed to remain in the contract following a reduction in the death benefit.
- In many instances, the adjustment rules characterize an excessive portion of a required distribution as a tax-free return of basis.

The flaws contained in the adjustment rules create an ineffective deterrent against strategies designed to inflate the investment orientation of life insurance contracts. The adjustment rules invite, rather than discourage, creative and abusive strategies. For this reason, they should be reconsidered.

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6. Market forces will not discourage the use of inflated mortality and expense charges. The actuarial limitations contained in section 7702 are based on maximum charges specified in the contract. I.R.C. §7702(c)(3)(B). The actual charges imposed are frequently less than the maximums specified in the contract.

VI. CONCLUSIONS AND RECOMMENDATIONS FOR LEGISLATIVE CHANGE

The preferential tax treatment of cash value life insurance policyholders is deeply flawed. Two policy goals purportedly justify the current tax treatment: (1) to encourage the provision of term insurance protection; and (2) to encourage savings for retirement. The current tax treatment of cash value life insurance does not promote these goals in a sensible manner. First, the existing provisions operate in a perverse fashion: they encourage taxpayers to reduce, not increase, their insurance protection. Second, the current tax treatment provides the greatest tax benefit to taxpayers whose insurance needs are modest, and no benefit to those with much greater insurance needs. In addition, unlike other retirement income provisions, no limitations are imposed on the dollar amount that can be set aside into tax-preferred retirement savings plans.

In addition, the definition of life insurance contained in section 7702 incorporates an inappropriate model of acceptable life insurance contract design. Use of the single premium model permits a far greater degree of investment orientation than would be appropriate, even if the social arguments raised in support of the existing tax treatment were valid. The single premium contract does not provide an acceptable balance between investment and insurance protection.

The state of the law could be improved if the tax incentives created to encourage the provision of cash value life insurance were targeted more effectively. Precise targeting would be achieved by limiting the exclusion from gross income to the interest income actually applied to pay the cost of term insurance protection. Alternatively, a modified version of section 7702 could adopt a variant of the level premium policy design as the most investment oriented contract that would receive life insurance status.

In addition, the changes proposed in H.R. 3441 to the distribution rules should be enacted. When cash is withdrawn from the life insurance contract, it becomes certain that the income will not be used to pay for term insurance protection or as a source of post-retirement income. Any justification for not taxing the interest income is eliminated.

Finally, several technical provisions contained in section 7702 may permit avoidance of this section's general limitations. Most significantly, the restrictions on the actuarial assumptions concerning mortality and expense charges are ineffective . Because use of inappropriate assumptions could reduce or eliminate any insurance feature from a life insurance contract, this inadequacy of section 7702 represents a major shortcoming.

APPENDIX

TABLE 1
LEVEL PREMIUM CASH VALUE LIFE INSURANCE

AGE	Opening Cash Value	Premium	Cost of Term Insurance Protection	Interest Earned	Closing Cash Value
35	0	1306	211	44	1139
36	1139	1306	221	89	2313
37	2313	1306	234	135	3521
38	3521	1306	249	183	4761
39	4761	1306	266	232	6034
40	6034	1306	284	282	7339
41	7339	1306	305	334	8674
42	8674	1306	325	386	10042
43	10042	1306	348	440	11440
44	11440	1306	371	495	12870
45	12870	1306	396	551	14332
46	14332	1306	421	609	15825
47	15825	1306	448	667	17351
48	17351	1306	474	727	18910
49	18910	1306	504	789	20502
50	20502	1306	533	851	22126
51	22126	1306	568	915	23778
52	23778	1306	607	979	25457
53	25457	1306	649	1045	27159
54	27159	1306	696	1111	28880
55	28880	1306	745	1178	30619
56	30619	1306	795	1245	32376
57	32376	1306	745	1314	34151
58	34151	1306	895	1383	35945
59	35945	1306	946	1452	37758
60	37758	1306	1001	1523	39586
61	39586	1306	1060	1593	41426
62	41426	1306	1124	1664	43273
63	43273	1306	1195	1735	45120
64	45120	1306	1270	1806	46962
65	46962	1306	1348	1877	48797
66	48797	1306	1426	1947	50625
67	50625	1306	1503	2017	52446
68	52446	1306	1578	2087	54261
69	54261	1306	1654	2157	56069
70	56069	1306	1736	2226	57865
71	57865	1306	1824	2294	59641
72	59641	1306	1923	2361	61386
73	61386	1306	1033	2426	63086
74	63086	1306	2148	2490	64734
75	64734	1306	2264	2551	66328
76	66328	1306	2375	2610	67870
77	67870	1306	2478	2668	69366
78	69366	1306	2570	2724	70827
79	70827	1306	2656	2779	72256
80	72256	1306	2742	2833	73653
81	73653	1306	2832	2885	75012
82	75012	1306	2930	2936	76325
83	76325	1306	3037	2984	77578
84	77578	1306	3145	3030	78770
85	78770	1306	3247	3073	79902
86	79902	1306	3338	3115	80985
87	80985	1306	3414	3155	82033
88	82033	1306	3473	3195	83061
89	83061	1306	3511	3234	84091
90	84091	1306	3528	3275	85144
91	85144	1306	3521	3317	86247
92	86247	1306	3486	3363	87430
93	87430	1306	3420	3413	88729
94	88729	1306	3335	3468	90168
95	90168	1306	3244	3529	91759
96	91759	1306	3169	3596	93493
97	93493	1306	3125	3667	95342
98	95342	1306	3065	3743	97326
99	97326	1306	2451	3838	100000

APPENDIX

TABLE 2
SINGLE PREMIUM CASH VALUE POLICY

AGE	Opening Cash Value	Premium	Cost of Term Insurance Protection	Interest Earned	Closing Cash Value
35	0	25408	211	1008	26205
36	26205	0	165	1042	27082
37	27082	0	175	1076	27983
38	27983	0	186	1112	28909
39	28909	0	198	1148	29859
40	29859	0	212	1186	30833
41	30833	0	228	1224	31830
42	31830	0	243	1263	32851
43	32851	0	260	1304	33894
44	33894	0	277	1345	34962
45	34962	0	296	1387	36053
46	36053	0	315	1430	37168
47	37168	0	334	1473	38307
48	38307	0	354	1518	39471
49	39471	0	376	1564	40659
50	40659	0	398	1610	41871
51	41871	0	424	1658	43104
52	43104	0	453	1706	44357
53	44357	0	485	1755	45628
54	45628	0	520	1804	46912
55	46912	0	556	1854	48211
56	48211	0	594	1905	49522
57	49522	0	630	1956	50847
58	50847	0	668	2007	52186
59	52186	0	706	2059	53539
60	53539	0	747	2112	54904
61	54904	0	791	2165	56277
62	56277	0	839	2218	57656
63	57656	0	892	2271	59035
64	59035	0	948	2323	60410
65	60410	0	1006	2376	61780
66	61780	0	1064	2429	63144
67	63144	0	1122	2481	64503
68	64503	0	1178	2533	65858
69	65858	0	1235	2585	67208
70	67208	0	1296	2636	68549
71	68549	0	1362	2687	69875
72	69875	0	1435	2738	71177
73	71177	0	1517	2786	72446
74	72446	0	1603	2834	73676
75	73676	0	1690	2879	74866
76	74866	0	1773	2924	76017
77	76017	0	1850	2967	77134
78	77134	0	1918	3009	78224
79	78224	0	1983	3050	79291
80	79291	0	2047	3090	80334
81	80334	0	2114	3129	81349
82	81349	0	2187	3166	82328
83	82328	0	2267	3202	83264
84	83264	0	2347	3237	84154
85	84154	0	2424	3269	85000
86	85000	0	2491	3300	85808
87	85808	0	2548	3330	86591
88	86591	0	2592	3360	87359
89	87359	0	2620	3390	88128
90	88128	0	2633	3420	88915
91	88915	0	2627	3452	90625
92	89740	0	2600	3486	90625
93	90625	0	2551	3523	91597
94	91597	0	2486	3564	92675
95	92675	0	2417	3610	93869
96	93869	0	2358	3660	95171
97	95171	0	2319	3714	96566
98	96566	0	2259	3772	98079
99	98079	0	1926	3846	100000

Chairman **Rangel**. Secretary Schweiker.

STATEMENT OF HON. RICHARD S. SCHWEIKER, PRESIDENT, AMERICAN COUNCIL OF LIFE INSURANCE, AND FORMER SECRETARY OF HEALTH AND HUMAN SERVICES

Mr. **Schweiker**. Mr. Chairman and members of the subcommittee, my name is Richard Schweiker. I serve as president of the American Council of Life Insurance. I am pleased to have this opportunity to present the views of the ACLI on the subject matter of these hearings.

The life insurance business is most pleased that the subcommittee is not in these hearings questioning the fundamental social value of life insurance, nor the basic tax treatment that has applied to life insurance since the inception of the income tax. Congress has repeatedly reaffirmed these principles.

I would stress, however, that the more narrow issues being addressed, and how they are resolved are extremely important. We understand the subcommittee is concerned regarding the increase in single premium life insurance sales and the investment orientation of some of the advertisements promoting single premium policies.

However, we do not believe these developments indicate that there is anything inherently wrong with single premium life insurance policies. Your focus should clearly be much more narrow. If the subcommittee decides to take action on the matters covered by this hearing, our message is simple, but critical.

Any legislation must be carefully crafted to avoid having a highly undesirable impact on the death benefit protection afforded millions of American families through the purchase of permanent life insurance, including single premium policies.

The long-standing congressional policy of recognizing the important social value of life insurance should not be eroded by overreaction to a concern which is limited to a relatively narrow segment of the life insurance business.

The subcommittee's announcement very clearly described a key test that should be applied. Proposals should be appropriate "without discouraging the purchase of life insurance as a means to provide death benefits for dependents."

In addition, we believe any legislation should apply to new policies only. It is not fair and it is contrary to general tax principles to change tax rules and to affect long-term commitments after they have been made.

Let me comment briefly on two specific proposals that have been advanced to deal with the perceived single premium problem; namely H.R. 3441 and the five-pay definitional approach. Both proposals in our view go too far. Both would fail the subcommittee's criterion of not discouraging the purchase of life insurance as a means to provide death benefits for dependents.

Our chief criticism of H.R. 3441 is that it would dramatically change the tax rules regarding withdrawals and loans in the case of all types of permanent life insurance. This would have a chilling effect on the purchase of all forms of permanent life insurance.

Purchasers of those policies, 68 percent of whom earn less than $30,000 per year, would be unlikely to buy them if their ability to borrow against the cash value in the event of unforeseeable need is subject to tax and penalties as provided by H.R. 3441. Moreover, the penalty is overkill adding one tax on top of another.

Our concern with the five-pay definitional approach is that an entire category of policies, those for which premiums are paid over less than 5 years would be denied life insurance tax treatment.

There is nothing inherently wrong in providing life insurance protection with a policy that is paid up after one or few premium payments. If such policies are purchased and used for life insurance purposes, they should be encouraged and not denied life insurance tax status.

This is particularly important at a time when this country's savings rate is woefully inadequate. Permanent life insurance is an important source of long-term capital.

We at ACLI have discussed extensively what solutions could be fashioned that would deal with the subcommittee's concerns regarding single premium policies but would not adversely affect the American public in its need for life insurance protection.

While the two approaches I have cited both go too far, we believe elements of each could be combined to satisfy both the subcommittee's and our concerns. For example, these elements could be combined as follows:

First, definitional elements could be used to narrowly target and focus on the specific policy types that the subcommittee considers susceptible to abuses; and second, distributional element could be included. That is, a change in the tax rules for policy loans and withdrawals, could then be applied to these narrowly defined policies.

This approach would retain the current tax law rules for all other life insurance products. This approach should be applied only to new insurance contracts, something which is consistent with general tax policy. If the subcommittee decides to draft legislation in this area, we would be glad to work with you to achieve a solution, a solution that balances your concerns about investment uses of single premium life insurance with those of maintaining the valuable social benefits provided by permanent life insurance.

Thank you.

[The statement of Mr. Schweiker follows:]

STATEMENT BY
RICHARD S. SCHWEIKER
FOR AMERICAN COUNCIL OF LIFE INSURANCE
AT THE HEARINGS OF
SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS
ON
INVESTMENT USES OF LIFE INSURANCE
MARCH 15, 1988

My name is Richard S. Schweiker, and I am appearing on behalf of the American Council of Life Insurance (ACLI). The ACLI represents 640 life insurance companies whose assets constitute approximately 94% of the assets of all United States life insurance companies. I am pleased to have this opportunity to present the views of the ACLI on the subject matter of these hearings, that is, the investment uses of life insurance.

The life insurance business is most pleased that the Subcommittee is not, in these hearings, questioning the fundamental social value of life insurance nor the basic tax treatment that has applied to life insurance since the inception of the income tax. Nevertheless, the issues being addressed and how they are resolved are extremely important.

Three points concerning the history of the taxation of life insurance policyholders are important to note as you begin to consider possible changes.

First, since the inception of the income tax, death benefits payable under life insurance policies have been excluded from gross income and policyholders have not been taxed on the inside build-up of their life insurance policies unless they actually receive it -- usually on surrender. This treatment has been examined time and time again and has been reaffirmed repeatedly. We strongly believe that this tax treatment is essential to encourage Americans to provide for the financial security of their families and dependents.

Second, in 1984 a comprehensive definition of which policies qualify for tax treatment as "life insurance" was added to the Code. Contained in Section 7702, the definition is designed to limit the funds that can be accumulated under a life insurance contract to those amounts deemed appropriate to provide the future benefits promised under the policy. That definition, now only four years old, was developed to prevent the use of life insurance policies primarily as investments. Several long-standing product designs were totally eliminated by section 7702 -- e.g., endowment and retirement income contracts where an excess of the death benefit over the available cash value may disappear during the insured's lifetime. Other products had to be redesigned to incorporate much larger death benefits (e.g., increasing face amount insurance).

Another essential feature of the definition is that it accommodates variations in methods of paying premiums.

The definition is conceptually sound.

Third, since the income tax was first enacted, the typical life insurance policy loan has never been considered in a taxable event. Over the years, Congress, the courts, and the IRS have reaffirmed this basic principle. A loan secured by the value of a life insurance policy is no different from a loan secured by any other property. Interest accrues on the loan and must be paid. Moreover, the policy loan does not extinguish the policyholder's ownership rights in the underlying policy.

The situation is analogous to that of a homeowner who takes out a home loan. Such a loan does not trigger a tax attributed to appreciation in the value of the house. The homeowner retains the rights and duties of ownership. Similarly, a life insurance policyholder who takes out a policy loan does not surrender any contractual right to his life insurance coverage but remains protected by the policy. If the policyholder repays the loan, the beneficiary is entitled to payment of the full amount of the death benefit without the insured having had to re-establish insurability or to pay higher premiums based on the insured's then attained age. In either the home or policy loan case, the only possible rationale for creating a taxable event is to equate the loan with a sale or distribution of part or all of the underlying collateral. This is simply not what occurs. Thus, there is no general tax principle supporting the taxation of policy loans.

Subcommittee Concerns and Proposals

We understand the Subcommittee is concerned that the increase in single premium life insurance sales and the investment orientation of some of the advertisements promoting single premium policies suggest that these contracts are being used, at least in some instances, as investment vehicles. These developments do not suggest, however, that there is anything inherently wrong with single premium life insurance policies. Since insurance costs increase with age -- and may become prohibitive at older ages -- permanent life insurance policies have traditionally been designed so that policy premiums are spread out over the insured's lifetime or are concentrated in those years when the insured's earning potential is greater. Thus, scheduled premium payments under whole life policies can range across the entire spectrum from level payments for life to a single payment at the beginning -- or there may be no prescribed schedule.

If the Subcommittee decides to take action on the matters covered by this hearing, the life insurance industry's message is simple but critical: any legislation must be carefully crafted to avoid having a highly undesirable impact on the death benefit protection afforded millions of American families through the purchase of permanent life insurance, including single premium. The long-standing Congressional policy of recognizing the important social value of life insurance should not be eroded by over-reaction to a concern which is limited to a relatively narrow segment of the life insurance business.

In this regard we note that the announcement of the hearings stressed that the Subcommittee will explore whether proposals are appropriate, "without discouraging the purchase of life insurance as a means to provide death benefits for dependents". This criterion is certainly the key for testing any proposal.

In addition, any legislation should only apply to new policies. It is not fair, and is contrary to general tax principles, to change the tax rules on long-term commitments after they have been entered into.

Let me now comment briefly on two specific proposals that have been advanced to deal with the perceived single premium "problem" -- H.R. 3441 and a 5-pay definitional approach. Both proposals go too far and would fail the Subcommittee's criterion of not discouraging the purchase of life insurance as a means to provide death benefits for dependents.

H.R. 3441: Our chief criticism of H.R. 3441 is that it would dramatically change the tax rules regarding withdrawals and loans and apply the changes to all types of permanent life insurance. Under this proposal, policy loans would be treated as distributions, distributions would be taxed using to an income-first rule rather than a cost-recovery first rule, and a penalty tax would be imposed on premature distributions.

We think these changes would have a destructive and chilling effect on the purchase of all forms of permanent life insurance. In this regard, 68% of permanent life insurance policies are sold to people earning less than $30,000. These people are less likely to buy permanent life insurance if their ability to borrow against the policy's cash value in the event of unforeseen financial need is subject to tax and penalties.

The broad changes proposed by H.R. 3441 are not justified. As noted earlier, under normal tax principles, policy loans are like any other loan secured by appreciated property. Interest accrues on the loan and must be paid. Moreover, the creation of the debt does not extinguish the policyholder's ownership rights in policy. We also note that because interest on consumer loans is no longer deductible, most policyholders are less likely to borrow against their policies except in emergencies.

A penalty tax is also overkill. It builds one tax on top of another and epitomizes the excessiveness of H.R. 3441.

5-Pay Definitional Approach: Under this proposal, an entire category of policies (generally those for which premiums are paid over less than 5 years) would be denied life insurance tax treatment. This goes too far. There is nothing inherently wrong in providing life insurance protection with a policy that is paid up after one or a few premium payments. If such policies are purchased and used for life insurance purposes, they should not be denied life insurance status. To the contrary, individuals should be encouraged to provide protection for their family in the event of their premature death, and to save for their retirement, health, or other essential needs. This is particularly important at a time when the nation's savings rate is inadequate, there are severe cutbacks in public assistance programs, and the needs of the elderly loom as a serious national problem. A single premium policy is as legitimate a product as any other life insurance product to provide this protection.

Recommendations

We at the ACLI have discussed extensively what solutions could be fashioned that would both (1) deal with the Subcommittee's concerns regarding single premium policies and (2) not adversely affect the American public and its need for life insurance protection. While the 5-pay definitional approach and H.R. 3441 both go too far, we believe elements of each could be combined to satisfy these two criteria.

For example, these elements could be combined as follows:

-- First, the definitional element could be used to narrowly target and focus on the specific policy types that the Subcommittee considers susceptible to abuses, and

-- Second, the distributional element (i.e., a change in the tax rules for policy loans and withdrawals) would then be applied to these narrowly defined policies.

It is important to emphasize that this approach would retain the current tax law rules for all other life insurance products. Moreover, any such approach should, consistent with general tax policy, be applied to only new insurance contracts.

We are exploring whether such an approach can be successfully developed.

If your Subcommittee decides to draft legislation in this area, we would be glad to work with you to achieve a solution that balances your concerns about investment issues of single premium life with the valuable social benefits provided by permanent life insurance.

Thank you. I will be glad to attempt to answer any questions the Subcommittee may have.

Mrs. Kennelly [presiding]. Thank you. The next witness will be Mr. Irons.

STATEMENT OF HON. WILLIAM V. IRONS, CLU, CHAIRMAN, FEDERAL LAW AND LEGISLATION COMMITTEE, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, AND STATE SENATOR FROM RHODE ISLAND, ACCOMPANIED BY WILLIAM V. REGAN III, CLU, MEMBER, TASK FORCE ON PRODUCT TAXATION

Mr. Irons. Madam chairman and members of the subcommittee, thank you for holding this hearing and for allowing the National Association of Life Underwriters to share our concerns and offer our suggestions. I am Bill Irons, chairman of the Federal Law and Legislation Committee. Bill Regan is with me, a member of our technical committee. NALU represents 135,000 professional life insurance sales people.

We career agents are concerned about overly investment oriented life insurance, especially single premium. We believe in permanent life insurance, and what it can and does do to provide financial security for over 100 million policy holders and their beneficiaries. It is this deep belief in the permanent life insurance product and in the very appropriate tax rules governing it that supports our opposition to H.R. 3441 or any proposal that would recharacterize loans against life insurance as taxable distribution.

As we have often testified before you, a policy loan is a true loan which must be repaid with interest. Under an income tax system, loan proceeds are not within the definition of income and thus are not taxed. Not only is this characterization of a loan against life insurance sound in principle, it is necessary to the decision to buy an adequate amount of permanent insurance. People will not, indeed often can't, commit two years of premium payments without the knowledge that should a financial emergency arise, they can borrow against their policies on a tax neutral basis.

Let us remind you of the thousands of small businesses and family farms that have survived after their owners' deaths because of permanent life insurance. Recall the educations that policy loans have made possible. Yet there is a problem. Some life insurance, especially single premium, is being marketed primarily as a tax sheltered investment. We agree that something must be done to stop this, but we believe the problem is not borrowing, despite the colorful ads that tout the no-cost, no-loan feature.

By the way, those loans are not really no-cost. They are paid for indirectly, but they are paid for. Even if you were to tax loan proceeds, there would remain a substantial tax-sheltered investment in the form of a low death benefit, single premium life insurance. NALU believes the solution to the single premium problem lies in restricting the amount of money that can be put into a life insurance policy.

The restrictions must be severe enough to repel pure investors, but not so harsh as to make the product non-competitive for those who need life insurance and are willing to pay it.

NALU proposes you amend section 7702, the definition of life insurance, to add an amount paid in limit. Mr. Regan will outline its details for you.

Mr. WILLIAM REGAN. The amount paid in limit would restrict the amount of money one could put into a policy to 20 percent of current laws maximum single premium for each of a 5-year holding period.

Further during the 5-year holding period, the mortality and expense assumptions used to calculate the maximum premium would be restricted. This changes current law under which both mortality charges and expense loads can be artificially raised in order to increase the amount of cash that can be put into a policy.

After the 5 years, the amount paid in limit would end, leaving current law restrictions to govern the policy. We suggest that this test be applied to all insurance contracts issued after the effective date. Compliance with the amount paid in limit as seen on page 9 of our statement results in loan values and after tax gains in early policy years which are approximately half of what is possible under current law. Surrender values also dropped substantially. As you can see in the illustration on page 10 of our statement, a policy that complies with our amount paid in limit compares poorly to both taxable and tax-free investments. Yet it still allows protection oriented life insurance to be bought with only one premium.

It treats all forms of life insurance, whole life, universal life, variable life, consistently and equally. It recognizes that loan proceeds are not income subject to tax. It wipes out any appeal life insurance might have for the pure investor, while allowing a competitive product for life insurance purchasers.

In short, it solves the problem of overly investment oriented life insurance without harming death protection oriented life insurance.

Mr. IRONS. In conclusion, we completely oppose H.R. 3441. It would deal a body blow to permanent life insurance, while potentially making only a negligible dent in single premium sales. We offer for your consideration the amount paid in limit as an effective alternative.

We thank you for the opportunity to testify.

[The statement of William Irons follows:]

STATEMENT OF WILLIAM V. IRONS, CLU, ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Mr. Chairman and members of the subcommittee, thank you for allowing us this opportunity to comment on the problem of the use of life insurance primarily as an investment. My name is William V. Irons, CLU. With me is William V. Regan, III, CLU. We both speak for The National Association of Life Underwriters (NALU), a trade association that with its over 1,000 state and local life underwriter associations represents over 135,000 professional life insurance agents from all parts of the country. I am chairman of NALU's Federal Law and Legislation Committee; Mr. Regan is a member of our committee's task force on product taxation. We thank you for holding this hearing.

The Problem Is Centered on Investment Orientation of Life Insurance

First, NALU agrees that there is a problem -- in market perception if not in fact -- in the use of life insurance primarily as an investment. The kind of "investment-oriented" life insurance most familiar to this committee is a single premium variable life insurance contract that offers a minimal or no cost loan feature. It is marketed as a vehicle for generating a stream of tax-free funds through use of systematic no-cost loans.

A review of the facts indicates that the marketing claims do not necessarily reflect what is actually happening. Attached to this testimony is a comparison of single premium life insurance (SPL), as available under current law, to single premium life insurance as it would be available under our proposed amendment, and to a single premium annuity, a taxable investment and a municipal bond. You'll note that in the first five years all three other investments outperform the single premium policy; either slightly, as it is allowed under current law, or substantially, as it is limited by our proposed amendment. Further, despite the marketing emphasis on loans, data to date suggest there is little actual borrowing. Only 7% of SPL policies have loans outstanding.

Nonetheless, current law single premium life insurance is more weighted toward investment than toward death protection. It can be -- and often is -- ordered through a stockbroker with essentially no underwriting required. The amount of death benefit provided in relation to investment yield is minimal. An investor will buy it -- to the tune of some $15 billion worth over the past four years -- often despite the fact that it provides some insurance. The belief that SPL policies are not being purchased for their life insurance benefits is reinforced by the fact that over the past four years, annual premium life insurance sales have held to a steady pattern of sustainable growth, while SPL sales have skyrocketed, at least doubling in each of the last four years.

Because of this heavy investment orientation, NALU believes SPL puts at risk the very appropriate tax rules that govern life insurance generally. Even if you view this product as good because of its long-term savings and capital accumulation features, it is impossible to justify its tax treatment based on its minimal life insurance characteristics.

Accordingly, to preserve what NALU profoundly believes is the appropriate tax treatment of the life insurance product, we offer for your consideration a proposal that will ensure that products taxed as life insurance are in fact primarily life insurance, yet at the same time they retain the competitiveness that will make them a good choice for the consumer who needs and wants both life insurance protection and a reasonably decent investment return.

Before getting into the specifics of our proposal, allow us to make a couple of points that are necessary to put both the problem and our proposal in the appropriate context. First, we are convinced that the problem is not the minimum number of premiums that should be allowed, nor what contract designs should be permitted. Thus, our proposal accommodates the need -- or desire -- to permit paid-up life insurance to be purchased with just one premium. And painstaking care was taken to be sure that our proposal treats all contract forms -- variable life, universal life, whole life, etc. -- consistently and equally. Similarly, to the extent life insurance products other than single premium may also be overly investment-oriented, they, too, are affected by our proposal. In short, we believe the problem is at the same time bigger and smaller than "single premium." Our proposal recognizes this in that it affects multi-pay policies that are tilted substantially more toward investment than toward death protection, while it would not adversely affect single premium contracts that are primarily life insurance policies.

The Definition of Life Insurance (IRC §7702) Should Be Amended to Add the Amount-Paid-In Limit

The statutory definition of life insurance should be modified by adding a new test to the existing cash value and guideline premium tests. The new test, "an amount-paid-in" limit, would restrict the amount of money a policyholder can pay into the contract per dollar of coverage for a specified timeframe in the beginning of the policy's life. The proposal also limits the charges which can be included in calculating the amount-paid-in limit in a way that does not prevent the issuer from reflecting its actual expenses over the lifetime of the contract.

Thus, the proposal has three key conceptual elements:

1. A statutory "holding period" during which the amount-paid-in test would have to be satisfied (disqualification of the contract as a life insurance policy is the contemplated result of failure to satisfy the test);
2. A lessening of the permissible initial funding level (to about 1/5 of the maximum single payment currently allowed); and
3. A statutory limit on the amount permitted to be included in the calculation of the maximum premium during the holding period to account for mortality and expenses to prevent circumvention of the amount-paid-in test.

Amount-Paid-In Limit

IRC §7702 should be amended to limit annual premiums that can be paid during the first five policy years to no more than 1/5 of the current law maximum single premium. The amount charged for mortality could not exceed the charges used to determine statutory reserves, and the maximum expense charge that could be used in the calculation of the amount-paid-in limit would be 10%. This proposal is designed to preserve the relationship between existing law's guideline premium and cash value tests during the holding period. The amount-paid-in limit should be applied to policies issued after the effective date, which we believe should be the date of enactment.

The Result

Policies that comply with the amount-paid-in limit would have a substantially reduced cash value per dollar of death benefit during the holding period years. This significantly reduces -- it is intended to eliminate -- the attractiveness of the policy as an investment unless a need for the total death benefit is present. The increased amount of insurance to be provided is substantial enough, in relation to the premium paid for it, that significant insurance risk is present, requiring more careful underwriting. In short, it results in life insurance risk, need and use as prerequisites to the purchase (and sale) of the policy.

Attached are illustrations showing how this limitation would work under various scenarios. Here, let us call your attention to examples numbered 4 and 5. Example number 4 is a typical single premium policy as it is being offered for sale today. It is neither the most investment-oriented policy available, nor the least. Example number 5 is the most investment-oriented policy possible under our amount-paid-in limit. Note that the before tax rate of return -- assuming the buyer does not value the life insurance protection -- drops from just over 7% to just over 5% in the fifth year. In the second year, the policy issued under current law is returning over 4½%, while under our proposal a positive rate of return doesn't occur until the third year — and then it's less than 2%, before tax. What these illustrations show is that during the holding period, earnings on premium dollars are being used mostly to buy death protection. In the illustration that compares SPL to annuities, taxable treasury bonds and municipal bonds, you'll note that in year five an SPL policy that complies with the amount-paid-in limit has an after tax rate of return of 3.7%, compared to 5.3%, 6.3% and 7.6% respectively on the other investments. Yet by year 20 -- and starting in year 6, when more generous current law limits control the cash that can be paid into the policy, the contract yields a not spectacular but respectable rate of return. Expiration of the restrictions imposed by the amount-paid-in limit are also important to avoid a result that would be essentially equivalent to price-fixing. Only three elements go into pricing a life insurance policy: the interest assumption, mortality charges and expense loads. During the holding period all three are strictly limited. And we believe that the need to expend substantial portions of premium earnings on death protection for five years will make the policy noncompetitive except for those who truly want life insurance. We firmly believe that a competitive product for those who do in fact want life insurance is not only appropriate, it is also necessary.

In summary, NALU supports limitations that will *both* prevent life insurance -- in whatever form -- from being used primarily as a tax-sheltered investment, *and* that preserve current law tax treatment of life insurance that is primarily death benefit-oriented. We offer you the amount-paid-in limit as a method of accomplishing these results.

Current Law Is Appropriate Tax Treatment of Life Insurance

Current law treats life insurance that is death benefit-oriented appropriately. Cash values accumulate income tax-free until surrender, as they should, for cash values are a by-product of the level funding mechanism that underpins the permanent life insurance product. Policy loan proceeds are not taxed nor should they be. A loan against a life insurance policy *is* a loan -- it must be repaid, with interest. The rate of interest charged is generally competitive in newer policies and in older policies that have been updated. And the loan interest rate was competitive or even higher than prevailing market rates at the time of purchase for old policies that have not been updated. In concept, loans against life insurance policies are not materially different from any other loan. In practice, marketplace differences are diminishing. For example, a growing number of home equity or line-of-credit loans have no structured repayment schedule. And interest charged on a loan collateralized by a C.D. (certificate of deposit) or money market fund can easily equal or exceed by very little the interest paid on the collateral! Under the principles of our income tax system, loan proceeds are not income and thus should not be taxed.

Proposals to solve the SPL problem by recharacterizing loans as taxable income fly in the face of this reality. Nor would taxable loans address more than the outer edges of the SPL problem. As noted earlier, available data show that only about 7% of all SPL policies have loans outstanding. Thus, for 93% of such purchases, the occurrence of a taxable event when borrowing occurs would have little or no effect on the decision to buy.

Yet, if a proposal to tax policy loans as broad as that embodied in H.R.3441 were to prevail, permanent life insurance -- even the least investment-oriented whole life policy -- would be crippled, while the tax shelter SPL policy would continue to flourish. This unfortunate result should be of grave concern to all of us who acknowledge the crucial role permanent life insurance plays in our economy and in the financial well-being of our society.

As we have testified before you often in the past, the ability to borrow on a tax-neutral basis against a life insurance policy -- even though such borrowing may never in fact be carried out -- is critical to the decision to purchase an adequate amount of permanent insurance. Such a purchase is a long-term commitment. The loan feature provides a safeguard against financial emergencies or unforeseen hard times. Lack of it, or tax-penalized borrowing, could result in decisions not to buy, to buy less than really needed, or to surrender the policy when the financial need arises.

There are many times when a business has survived because of policy loans and when education has been made possible because of loans against life insurance policies, to cite just two examples of the utility of policy loans.

To imperil the widespread good that results from a substantial amount of permanent insurance in force by accepting a cripplingly overbroad proposal that would be, we believe, a futile attempt at stopping a tax shelter would be a mistake near-tragic in proportion.

NALU strongly opposes H.R.3441. It would deal a body blow to permanent insurance generally while making a potentially negligible dent in the sale of investment-oriented life insurance.

Conclusion: Enact the Amount-Paid-In Limit to Prevent Life Insurance From Being Used Primarily as an Investment

NALU, with essential cooperation from its conference, the Association for Advanced Life Underwriting, and from the attorneys and actuaries of many life insurance companies, has studied this problem for nearly a full year before developing the proposed amount-paid-in limit. Literally scores of approaches were examined and rejected, either because the tax shelter would remain -- albeit under a different design, or because the impact would have been broader than the problem. We believe the amount-paid-in limit is the best way to prevent life insurance from being used primarily as a tax-sheltered investment, while -- just as importantly -- preserving the competitiveness of death benefit-oriented policies. In summary:

- This proposal is intended to shut down the use of life insurance primarily for tax-free capital appreciation or as a mechanism for generating a stream of tax-free income. NALU fully intends that result and believes the proposal will accomplish it. The product will be unattractive to investors who have little or no need for death protection and do not want to pay for it.

- The proposal does not defy basic realities: a loan against a life insurance policy is a loan, and loan proceeds, under the principles of an income tax system, are not "income" subject to tax.

- The proposal accommodates the need to restrict the use of life insurance as a tax shelter regardless of the policy's form.

- The proposal does not upset the delicate balance of §7702 as it currently exists. The guideline premium, cash value and corridor tests, and existing computation rules remain essentially unchanged. The proposal is designed to be neutral with respect to various product designs.

- Circumvention of the new test will be prevented by imposition of appropriate actuarial assumptions and technical rules (for example, for decreasing and increasing death benefit policies, joint life contracts, term riders, etc.).

- Because this test only limits the amounts paid into the contract for the first five years, it in no way limits the actual expense loads or other charges that can be built into the contract's pricing.

Therefore, we urge you to support this proposal, and enact it as soon as is reasonably possible; and at the same time reject the overbroad and dangerous provisions of H.R.3441.

Thank you for this opportunity to present our views.

Proposed Statutory Language

This proposed amendment would add a new subsection (e) to section 7702 and all subsequent sections would be renumbered.

Replace the period at the end of subsection (a)(2)(B) with a comma, and add the following:

and

(3) meets the amount paid-in test of subsection (e).

Add subsection (e):

(e) AMOUNT PAID-IN TEST FOR SUBSECTION (a)(3).--For purposes of this section--

(1) IN GENERAL.--A contract meets the amount paid-in test of this subsection if the accumulated amount paid into the contract does not at any time during the first five policy years exceed the amount paid-in limitation.

(2) AMOUNT PAID-IN LIMITATION.--The term "amount paid-in limitation" means, as of any date, the greater of:

(A) the sum of the premiums that could have been paid on or before that date computed as if the contract provided for level annual premiums of $500, or

(B) the sum of the net level premiums that could have been paid on or before that date computed as if the contract provided for five level annual premiums, each equal to twenty-two percent of

(i) in the case of a contract to which subsection (a)(1) applies, the net single premium for the contract as determined under subsection (b), or

(ii) in the case of a contract to which subsection (a)(2) applies, the guideline single premium determined under subsection (c).

(3) COMPUTATIONAL RULES.--

(A) IN GENERAL.--The determinations under this subsection shall be made by applying--

(i) in the case of a contract to which subsection (a)(1) applies, subsection (b)(2), and

(ii) in the case of a contract to which subsection (a)(2) applies, subsection (c)(3)(B).

(B) SPECIAL RULES.--For purposes of applying subparagraph (A)--

(i) the mortality charges used in determining the statutory reserves for such contracts are to be used under subsection (c)(3)(B)(i);

(ii) no charges are to be taken into account under subsection (c)(3)(B)(ii);

(iii) subsection (c)(3)(C) shall apply without regard to subsection (f)(7); and

(iv) subsection (f)(7)(A) shall not apply.

(4) If there is a reduction in the death benefit under the contract within the first five contract years that was not taken into account in determining the amount paid-in limitation, the amount paid-in test shall be reapplied to the policy as of all contract dates from the date of issue as if the reduction had been scheduled at the time of issue.

(5) EFFECTIVE DATE.--The amount paid-in test shall apply to all contracts issued after [ ].

Amend paragraph (f)(1):

(1) Premiums and Amounts Paid.--

(A) In General.--

(i) For purposes of subsection (c), the term "premiums paid" means the premiums paid under the contract less amounts (other than amounts includible in gross income) to which section 72(e) applies and less any excess premiums with respect to which there is a distribution described in subparagraph (B) or (E) of paragraph (7) and any other amounts received with respect to the contract which are specified in regulations.

(ii) For purposes of subsection (e), the term "amount paid" means (I) the gross premiums paid under the contract, less (II) amounts to which section 72(e) applies to the extent that such amounts are used to reduce premiums.

(B) Treatment of Certain Premiums or Amounts Returned to Policyholder.--If, in order to comply with the requirements of subsection (a)(2)(A) or (a)(3), any portion of any premium or amount paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of a contract year, the amount so returned (excluding interest) shall be deemed to reduce the sum of the premiums paid under the contract, or the amount paid into the contract, during the year.

EFFECT OF AMOUNT PAID-IN TEST ON PREMIUMS, COVERAGE, LOANS & INTERNAL RATES OF RETURN

Product Type:	**Back end loaded product (declared rate of interest reduced only by mortality)**
Assumptions:	**$100,000 initial death benefit, male age 55**
Guarantees:	**1980 CSO, 4%, whole life, curtate functions; 10% load**
Experience:	**60% 1980 CSO, 8.75% interest, after expenses except mortality**

Internal rates of returns (pages 1 and 2) are before tax and assume that insurance protection has no value.

Example 1: CURRENT LAW – Single Premium Life (Cash Value Test)

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$110,514	$50,373*	$ 50,589	+ 0.43
2	$116,123	$ 0	$ 55,202	+ 4.68
3	$122,037	$ 0	$ 60,213	+ 6.13
4	$128,273	$ 0	$ 65,657	+ 6.85
5	$134,847	$ 0	$ 71,568	+ 7.28
10	$173,621	$ 0	$107,344	+ 7.86
20	$292,650	$ 0	$221,523	+ 7.69

* *The maximum premium permitted by the amount paid in test for $100,000 of protection.*

Example 2: PROPOSED LAW – Death benefit similar to Example 1 (CV test) (initial premium is significantly reduced)

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$100,000	$10,075	$ 9,639	- 4.30
2	$100,000	$10,075	$ 20,358	+ 0.70
3	$100,000	$10,075	$ 32,281	+ 3.30
4	$100,000	$10,075	$ 45,546	+ 5.00
5	$113,407	$10,075	$ 60,188	+ 6.00
10	$146,015	$ 0	$ 90,276	+ 7.50
20	$246,118	$ 0	$186,301	+ 7.50

Example 3: PROPOSED LAW – Same initial premium as Example 1 (CV test) (required coverage is higher throughout first five contract years)

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$500,000	$50,373	$ 48,194	- 4.30
2	$500,000	$ 0	$ 49,939	+ 0.40
3	$500,000	$ 0	$ 51,550	+ 0.80
4	$500,000	$ 0	$ 52,990	+ 1.30
5	$500,000	$ 0	$ 54,213	+ 1.50
10	$131,520*	$ 0	$ 81,314	+ 4.90
20	$221,686	$ 0	$167,807	+ 6.20

* *Death benefit reduced to $78,352 in year 6 (paid-up).*

Example 4: CURRENT LAW – Single Premium Life (Guideline Premium Test)

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$100,000	$36,337	$ 36,368	+ 0.08
2	$100,000	$ 0	$ 39,572	+ 4.36
3	$100,000	$ 0	$ 43,071	+ 5.83
4	$100,000	$ 0	$ 46,896	+ 6.59
5	$100,000	$ 0	$ 51,085	+ 7.05
10	$100,000	$ 0	$ 77,527	+ 7.87
20	$235,026	$ *	$229,682	+ 8.16

Example 5: PROPOSED LAW – Death benefit similar to Example 4 (GLP test) (initial premium is significantly reduced).

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$100,000	$ 7,267	$ 6,782	- 6.20
2	$100,000	$ 7,267	$ 14,306	- 1.10
3	$100,000	$ 7,267	$ 22,657	+ 1.90
4	$100,000	$ 7,267	$ 31,928	+ 3.80
5	$100,000	$ 7,267	$ 42,225	+ 5.10
10	$100,000	$ *	$ 62,796	+ 7.00
20	$200,340	$ *	$195,785	+ 7.80

** Gross premium paid in year 11 – $2,977; gross premium paid in year 12 and in all subsequent years – $3,574.*

Example 6: PROPOSED LAW – Same initial premium as Example 4 (GLP test) (required coverage is higher throughout first five contract years).

Year	Death Benefit	Gross Premium	Cash Value	Internal Rate of Return
1	$500,000	$36,337	$ 33,909	- 6.70
2	$500,000	$ 0	$ 34,128	- 3.10
3	$500,000	$ 0	$ 34,042	- 2.20
4	$500,000	$ 0	$ 33,591	- 2.00
5	$500,000	$ 0	$ 32,706	- 2.10
10	$ 86,605*	$ 0	$ 47,962	+ 2.80
20	$106,683	$ 0	$104,257	+ 5.40

** Death benefit reduced to $63,370 in year 6 (largest reduction in death benefits allowable that will not force further changes to be made to the contract to comply with Section 7702).*

COMPARISON OF POLICY RESULTS

Product Type: Back end loaded Product (declared rate of interest reduced only by mortality)
Assumptions: $100,000 initial death benefit, male age 55
Guarantees: 1980 CSO, 4%, whole life, curtate functions; 10% load
Experience: 60% 1980 CSO, 8.75% interest, after expenses except mortality

	CASH VALUE TEST PRODUCT			GUIDELINE PREMIUM TEST PRODUCT		
	MAXIMUM CURRENT LAW	AMOUNT PAID IN TEST		MAXIMUM CURRENT LAW	AMOUNT PAID IN TEST	
PREMIUMS YEAR		5 PAY	1 PAY		5 PAY	1 PAY
	[EX. 1]	[EX. 2]	[EX. 3]	[EX. 4]	[EX.5]	[EX. 6]
1	$50,373	$10,075	$50,373	$36,337	$7,267	$36,337
2	$ 0	$10,075	$ 0	$ 0	$7,267	$ 0
3	$ 0	$10,075	$ 0	$ 0	$7,267	$ 0
4	$ 0	$10,075	$ 0	$ 0	$7,267	$ 0
5	$ 0	$10,075	$ 0	$ 0	$7,267	$ 0
CASH SURRENDER VALUE						
1	$50,589	$ 9,639	$48,194	$36,368	$ 6,782	$33,909
2	$55,202	$20,358	$49,939	$39,572	$14,306	$34,128
3	$60,213	$32,281	$51,550	$43,071	$22,657	$34,042
4	$65,657	$45,546	$52,990	$46,896	$31,928	$33,591
5	$71,568	$60,188	$54,213	$51,085	$42,225	$32,706
FIVE YEAR RESULTS - SURRENDER VALUE						
CASH SURR VALUE	$71,568	$60,188	$54,213	$51,085	$42,225	$32,706
- PREMIUM	$50,373	$50,375	$50,373	$36,337	$36,335	$36,337
= GAIN	$21,195	$ 9,813	$ 3,840	$14,748	$ 5,890	$ 0
- TAX @ 28%	$ 5,935	$ 2,748	$ 1,075	$ 4,129	$ 1,649	$ 0
A/T GAIN	$15,260	$ 7,065	$ 2,765	$10,619	$ 4,241	$ 0
% OF CURRENT LAW MAX	--	46%	18%	--	40%	0%
FIVE YEAR RESULTS - LOAN FROM EARNINGS						
1	$4,024	$ 289	$1,449	$ 2,769	$ 25	$ 124
2	$3,976	$1,193	$1,178	$ 2,750	$ 658	($ 135)
3	$3,927	$2,116	$ 896	$ 2,736	$ 1,304	$ 0
4	$3,871	$3,059	$ 595	$ 2,724	$ 1,962	$ 0
5	$3,812	$3,907	$ 270	$ 2,720	$ 2,639	$ 0
TOTAL	$19,610	$10,564	$4,388	$13,699	$6,588	($ 11)
% OF CURRENT LAW MAX	--	54%	22%	--	51%	-0%

COMPARISON OF INVESTMENT RESULTS

ASSUMPTIONS

SINGLE PREMIUM LIFE: Same as Page 1. Current law products with normal mortality and expense load.
MAXIMUM PREMIUM-AMOUNT PAID IN TEST: Same as Page 1.
SINGLE PREMIUM DEFERRED ANNUITY: 8.75% interest; 7% decreasing surrender charge; no charge on withdrawal of interest; 10% penalty tax in Year 5.*
TAXABLE INVESTMENT: 8.4% 20 year taxable Treasury Bonds - as of 02/09/88
MUNICIPAL BOND: 7.6% 20 year tax free municipal bonds - as of 02/09/88.

PREMIUM OR INVESTMENT YEAR	SINGLE PREMIUM LIFE [EX. 4]	MAXIMUM PREMIUM AMT PAID IN TEST [EX. 5]	SINGLE PREMIUM DEFERRED ANNUITY	TAXABLE INVESTMENT	MUNICIPAL BOND
1	$36,337	$ 7,267	$36,337	$36,337	$36,337
2	$ 0	$ 7,267	$ 0	$ 0	$ 0
3	$ 0	$ 7,267	$ 0	$ 0	$ 0
4	$ 0	$ 7,267	$ 0	$ 0	$ 0
5	$ 0	$ 7,267	$ 0	$ 0	$ 0
TOTAL	$36,337	$36,335	$36,337	$36,337	$36,337
SURRENDER VALUE					
1	$36,368	$ 6,782	$36,750	$39,389	$39,099
2	$39,572	$14,306	$40,396	$42,698	$42,070
3	$43,071	$22,657	$44,398	$46,285	$45,267
4	$46,896	$31,928	$48,791	$50,173	$48,708
5	$51,085	$42,225	$53,613	$54,387	$52,410
FIVE YEAR RESULTS - SURRENDER VALUE					
CASH SURR VALUE	$51,085	$42,225	$53,613	$54,387	$52,410
- PREMIUM OR INVESTMENT	$36,337	$36,335	$36,337	$36,337	$36,337
= GAIN	$14,748	$ 5,890	$17,276	$18,050	$16,073
- TAX @ 28%	$ 4,129	$ 1,649	$ 6,565*	$ 5,054	$ 0
A/T GAIN	$10,619	$ 4,241	$10,711	$12,996	$16,073
A/T IRR	5.26%	3.70%	5.30%	6.31%	7.60%
FIVE YEAR RESULTS - LOAN FROM EARNINGS, FOR WITHDRAWAL OF A/T INTEREST					
1	$ 2,769	$ 25	$ 1,971	$ 2,198	$ 2,762
2	$ 2,750	$ 658	$ 1,971	$ 2,198	$ 2,762
3	$ 2,736	$ 1,304	$ 1,971	$ 2,198	$ 2,762
4	$ 2,724	$ 1,962	$ 1,971	$ 2,198	$ 2,762
5	$ 2,720	$ 2,639	$ 1,971	$ 2,198	$ 2,762
TOTAL	$13,699	$ 6,588	$ 9,855	$10,990	$13,808

Chairman Rangel. Thank you, Mr. Irons.

That 7 percent of single premium policy of loans outstanding is really a surprising statistic for me. Is that projected that they will not take loans out late or do you have any idea why it is so low? I thought most people took out those single premiums so they could borrow the money.

Mr. Irons. Mr. Chairman, that is a study, statistic, and it recognizes that in the early years, the beginning years, the loans are taken out at the end of the contract, and since single premium really has grown drastically in the last several years, it is really just a benchmark at this point, not a projection in any way of what may come.

Chairman Rangel. So you are saying that even though that is what you know now, that you believe, that there would be loans at the later part of the contract.

Mr. Irons. The product lends itself to that, surely. That is the way——

Chairman Rangel. The product lends itself to that, and then that 7 percent figure really—I mean people bought the single premium for the loan.

Mr. Irons. Many, without question, truly, Mr. Chairman.

Chairman Rangel. What good is your 7 percent figure?

Mr. Irons. One point that we are putting on record, what happened to date, however, there is a parallel in the industry, Mr. Chairman, that is what is called a minimum deposit that used to exist under the 4 out of 7 rule.

In fact, and I am a detailed person who deals with a client, Mr. Chairman, that was a policy concept that was sold that you sell the policy and you borrow—I mean pay the 4 or first 7. However, much of that business was never eventually utilized that way.

It was a sales technique. When you really are borrowing to this concept that is being marketed, the marketing quite often is very deceptive and, in fact, many of the people will leave the money in. We are not defending single premium, please understand that. In fact——

Chairman Rangel. I know. What good is the 7 percent figure to the Committee?

Mr. Irons. Just to show in the early years of the concept how—I think many would believe that 50 percent of policies——

Chairman Rangel. We still have a wrestle with the short fall and potential abuse.

Mr. Irons. True, without question.

Chairman Rangel. Mr. Secretary, is it your testimony that loans from life insurance policies should not be taxed?

Mr. Schweiker. We are opposed to the breadth of Mr. Stark's bill and that opposition is basic to our testimony. In looking for a solution, we are working in the area where we might combine a definitional and a distributional approach.

Chairman Rangel. Right now you believe that you should be able to borrow from the policy and not pay taxes on the money, even if you don't intend to repay the loan.

Mr. Schweiker. It is our position that, in general, policy loans should not be taxed, yes.

Chairman Rangel. And——

Mr. Schweiker. I am not clear whether you are talking about all policies, or simply single premium policies.

Chairman **Rangel.** Well, let's talk about single premium policy. Would you say that if you borrowed money without any intention of paying it back under the existing single premium policy, that you should not be taxed on that so-called loan?

Mr. Schweiker. No. We are saying that we believe you can fashion a proposal that will target the problem so that you don't use such policies as an investment product. By doing that, you would put some kind of a tax on a loan from a single premium product.

Chairman **Rangel.** Mrs. Kennelly.

Mrs. Kennelly. Yes. Gentlemen, you have heard testimony from Professor Pike that a level premium test could be formulated. Could you comment on that in light of your proposals?

Mr. William Regan. Well, we have proposed a level premium test that continues for five years and that obviously could be continued for 10 years, as I believe he stated, or some of the other people testified today have stated it.

There are reasons why you don't want to continue a maximum capitalization what can be charged for life insurance for a period of time. There are significant policy reasons but it is possible, and we felt that the reason for the 5-year test that we have proposed, was that it would deter pure investors from getting involved in the enterprise where they would buy large amounts of life protection, protection in it. We felt a 5-year period would be sufficient to deter investors from making the pure——

Mrs. Kennelly. Thank you, sir.

Mr. Pike, to be fair, now, you have heard the comments on distributional and definitional as a combination from these gentlemen. Have you got any further comments on that? Have you changed your mind at all in your testimony that you originally said?

Mr. Pike. Have I changed my mind, no.

Mrs. Kennelly. I didn't think you had. Do you want to comment, though?

Mr. Pike. I think——

Mrs. Kennelly. Let me do it this way. I heard you and then I heard them.

Now, my understanding of what you said is that what they are suggesting isn't enough. Could you comment on that further?

Mr. Pike. Certainly. The question of what remedy you fashion, whether you go to a 5-year limitation such as suggested, or a level premium model for a much longer period of time depends on what you perceive the problem to be.

Mrs. Kennelly. That is one of our problems.

Mr. Pike. That is right. As I understand their analysis and try to read a little between the lines, NALU is saying that the only problem is that contracts may be purchased by somebody who has absolutely no interest whatsoever in getting insurance protection, but who would buy it purely and simply as a tax-sheltered investment.

I think that everyone agrees that a contract that is purchased for these reasons should not be treated as life insurance for tax purposes. I would go further. I would ask what behavior are you trying to encourage by taxing cash value life insurance in a favorable manner? I believe that the primary reason is to encourage people to protect their families.

If that is the reason, then you want the amount of interest that is excluded from the tax system to be commensurate with the cost of insurance you are encouraging people to buy. If this is the policy justification for the current tax treatment of life insurance, then I believe a level premium policy is a better model.

I agree that it is not something we could draft in the next 10 minutes, but I think it is draftable and I think it is sensible.

Mrs. **Kennelly**. Thank you, sir.

You didn't change your mind. Thank you, Mr. Chairman.

Chairman **Rangel**. Mr. Brown.

Mr. **Brown**. Thank you, Mr. Chairman.

Professor Pike, I want to commend you on an excellent testimony. Your statement is very helpful in dealing with the concepts. Let me ask you on the point that Mrs. Kennelly just made and brought out. If a goal were to be to make the amount of interest equal to the insurance cost or the amount of interest in which a tax is deferred, equal to the insurance cost, would you focus on real interest or stated interest? Obviously, the difference is very important.

Mr. **Pike**. Absolutely. My answer is that you should, analyze interest credited under life insurance in the same manner as interest that is generally subject to tax. Your concern about inflation and real rates of return is quite legitimate.

In 1984, the Treasury suggested an approach to deal with the effects of inflation on investments. One-half of their solution was to exclude from income the inflationary return, the 6 percent that you talked about in your earlier example.

That makes sense only if you deny a deduction to the person paying the interest that represents the inflationary component of the total return. What that would translate as, and I think I would turn to my co-panelist from the ACLI, would be disallowing a deduction for the insurance companies for that portion.

Mr. **Brown**. I am not asking about borrowing on the insurance policy. I am asking about building the policy, or a test for a policy. That is in defining that policy as to what is acceptable, you work it out so that the amount of interest is roughly equal to the cost of insurance. That doesn't involve the offsets, I don't think, that you are talking about.

I guess the point is if you are talking about real interest, that you are probably not far from that right now, are you. I assume there is some policy sold where the interest accumulated does not even keep up with the rate of inflation, and certainly through the 1960's that would have been the case for almost every insurance policy.

Mr. **Pike**. Absolutely.

Mr. **Brown**. If you are talking about a definition of where you make the insurance cost roughly equal to the interest that is earned on the balance, and you don't take account of inflation, you have guaranteed that every policy will be a loser, haven't you in real terms?

Mr. **Pike**. I wouldn't be looking at life insurance as pure investment so much as looking at it as a way to get insurance protection provided with untaxed dollars. The investment return would not reflect long-term accumulation, but would be applied annually to pay for the insurance protection.

Mr. **Brown**. If you don't take account of inflation, you have given no coverage whatsoever. What you have done is consumed the value of those dollars in insurance coverage.

Mr. **Pike**. I agree with you that an ideal system would take into account inflation and that you should take inflation into account when defining life insurance. You also should take inflation into account in determining income from all other investment sources. I think it is a miscalculation, however, if you taxed investments only on real gains, but you did not deal with inflation systematically.

Mr. **Brown**. You are talking about comparability to other things. I know the Treasury was deeply concerned about tax accountants and attorneys not having enough business when they came up with that proposal. I think they have solved that problem. One aspect of this that is intriguing to me, and maybe you can give me a rough estimate, do you or do other members of the panel have a feel for the portion of policies that are terminated by payment of the death benefits, therefore, getting that tax benefit versus being cashed in at some point? Since that appears to be a major tax advantage of insurance, do we have a feel for what that generally is, how significant is that?

Mr. **Schweiker**. I'd like to have Richard Minck, our executive vice president respond.

Mr. **Minck**. The answer to that will vary by the type of policy and type of market you are in. I would say 40 or 50 percent of the permanent policies that had been issued in a period in the past might have been surrendered or had something done with them before the death of the policyholder, and the balance probably resulted on death benefits.

Mr. **Irons**. I want to add a very important point. You were talking about permanent insurance. Term insurance, which is not in this discussion, has a much lower retention to the point of death. Why one—one of the reasons why permanent insurance is such an important vehicle in our society is because it is maintained at a much higher rate to the point of death, providing the values that the buyer originally was involved in in the decisionmaking process.

Mr. Brown. Am I right in thinking that when a policy is cashed in, rather than terminated by death benefits paid out, the policyowner has to recognize and pay tax on any gain?

Mr. **Irons**. Did you say by death?

Mr. **Brown**. Surrendering.

Mr. **Irons**. Yes, sir.

Mr. **Brown**. So in those circumstances, we are not looking at a tax-free build up, we are looking at a tax-deferred build up. Is that accurate?

Mr. **Irons**. Exactly right, yes, sir.

Mr. **Brown**. Thank you, Mr. Chairman.

Chairman **Rangel**. Mr. Guarini.

Mr. **Guarini**. Thank you, Mr. Chairman.

I appreciate being here. I am very interested in the subject matter. I haven't been here earlier and had the benefit of the testimony of this important panel. I was over at the budget hearing and there were key meetings being held there. I do think it is very important that we resolve this issue. I wanted to thank the National Association of Life Underwriters and the American Council of Life Insurance for trying to come to a resolution.

It is necessary that we develop capital formation in our country. That is the thing that we are hurting on the most, and our savings are terribly low and we are borrowing $150 billion abroad in order to survive within our economy. I think that we should be sure that we come upon a program that is going to not only meet the interest of the United States, but the best interests of our economy in regard to getting capital formation.

Now, if I were to invest $100,000 in a single premium life policy and I were an investor, would I be inclined to put it in a long, long-term bond, for instance. In other words, would I invest $100,000 for—in 20 or 30 years I may have in my life expectancy in long, long-term bonds? I don't think so. It wouldn't be considered a wise investment, perhaps. So I don't know whether or not it is a total investment, and if I were to invest $100,000 and I got 8 percent tax free on my money, I imagine that 4 percent of that, or half, would probably be the cost of living increase on my money, and all I would be, in fact, getting would be 4 percent real interest returned; and, of course, that is the amount of money that would be really dealing with as far as a short fall to the U.S. Treasury. I don't think anybody is against the concept of inside build up.

The ads have exercised an awful lot of people and I think they were abusive in the way they were forthcoming. But if we have to take away the tax-free borrowing, that to me would be the maximum abuse that we have in regard to the policy, not that it is just strictly an investment policy. When I look at real estate, for instance, people can buy real estate and they can, within our Tax Code, depreciate the real estate, and have value at the end of the full depreciation which is in excess of life term, and still take all their money tax free.

And then they can refinance and take all their money again tax free. That is more of an abuse of the fairness within the tax system. When it comes to personal property, we don't, within our system, justify for the life of the property. We go for the property on a depreciation scale where it may live much longer than our depreciation table.

So, Mr. Chairman, I kind of think that the issue here should be resolved as to whether or not there is abuse within the borrowing capacity from year to year. This is what seems to make people feel that—that the fairness within the Tax Code doesn't exist in single premium policies. Do you agree or disagree with that basic premise, that it is the tax-free borrowing which appears to be the unfairness within the system, that people are exercised about?

Mr. SCHWEIKER. Congressman, I will take the first stab at it. I pretty well agree with your premise. That is one of the reasons that the concept that the ACLI is working on, targets the single premium policies in terms of withdrawals and borrowing. So our solution that we are working on responds exactly to the heart of your question.

Mr. GUARINI. Would NALU's premise help that, too. Because I imagine you can structure a policy in so many different ways and there are so many different creative minds that we have. As long as we eliminate what we perceive to be the abuse and get down to why tax reform happened last year, it wasn't made simpler. It wasn't made for the sense of the economy. It was made because of the fairness perception, that people didn't feel that our Tax Code was fair and, as a result, there is a dropping of compliance in a voluntary system of taxation.

And if fairness is our basic issue and that is what is concerning us, I am wondering whether or not if we drive to that one particular item, whether or not it would satisfy NALU and satisfy the American Council of Life Insurance and, at the same time, be a common denominator of satisfying this committee that they have struck a fair Tax Code.

Mr. IRONS. I think the answer to your question has to be no. The real abuse from the Treasury's point of view is lost revenues. If you tax withdrawals, you won't stop the moneys going into the policies and hence you won't develop the revenues.

On the other hand, and I say this again as a field salesman, you will stop middle-income America from being able to take the burden of the Federal Government when the breadwinner dies and the family does not have support. That person, historically, has put his or her money into cash value life insurance, has left it there until recently, when circumstances of unusually high interest rates caused some disintermediation. Unusually, only dire emergencies will cause a policyholder to reach to his or her insurance policy.

If you impose upon middle-income America the inability in emergencies to reach their funds, you will, in essence, kill the sale for middle-income America. You will not hurt the large investor. The end result of that will be when the family or breadwinner dies there will be no replacement of the lost income; when the corporation dies, the jobs his corporation provided will be lost. The financial consequences will fall back to the Federal Government, creating a need for yet more revenues. So the idea of taxing withdrawals does nothing at all to stop the loss of revenue to the Federal Government. In fact, to the extent that taxable loans discourages life insurance purchases, it could lead to an increase in lost revenue.

Mr. GUARINI. If this investment was put into industrial expansion and building homes, and things like that, I imagine there is a retro feedback where there could be that much more velocity of money and that much more taxes that would be paid, by more jobs and more taxpayers, and more successful businesses.

Mr. IRONS. Let me go back, if I could, Mr. Guarini. One thing has been lost in this discussion today, because with single premium, this whole discussion this morning has been talking about life insurance as an investment. Life insurance did not turn out that way. In fact, the way the contracts are structured between the two parties is actually a unilateral agreement, the position is such that the person who buys the policy is not investing money.

As a part of the contract, he has the option to go to the insurer and ask for the insurer's money, which it is. The layman doesn't understand that, but it is, and to put together a loan as he would with a bank. So if you want the money for the infrastructure of our economy, it should go elsewhere, but not encouraged by shutting off tax-free withdrawals from life insurance policies.

Mr. GUARINI. Do you think that a $100,000 single premium policy would be considered a viable investment if you held that insurance policy for, say, 30 years?

Mr. IRONS. I don't—I apologize, I don't understand the question.

Mr. GUARINI. Well, if you take $100,000 and put it in a bond, would you buy a 30-year bond in the course of your life time, not knowing what inflation rates are going to be, going up or down or the state of the economy within the next 10, 20, 30 years?

Mr. IRONS. My answer to that, and I am not being flippant, it would depend upon the investor. There are those who do that.

Mr. GUARINI. It is institutions, but not individuals, I don't think.

Mr. IRONS. The individuals I know are as varied as the institutions and they make investments on their own risk profiles. I know what you are driving at, but I can't say categorically someone wouldn't do that.

Mr. GUARINI. Mr. Regan, do you have an opinion?

Mr. WILLIAM REGAN. I would agree with Mr. Irons. I would agree that, you know, the opportunity to make long-term investments is not the typical thing, particularly in the last few years, but I think a single premium life insurance policy purchased by a $100,000 single premium has a tremendous opportunity for an enormous amount of tax-free inside growth, that isn't needed to provide death benefits, and if any are used, if the position is anything, it is that we want to encourage protection oriented insurance.

The life insurance product being marketed isn't that. That is the reason for our proposal.

Mr. FLIPPO [presiding]. The time of the gentleman is up.

Mr. GUARINI. It is a matter of—maybe lifetime benefits can be a term we should consider, too.

Mr. FLIPPO. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

I want to thank the panel for coming and giving us their insights today. I have been doing some independent study of single premium policies.

I have attempted to find a policy that offers all the benefits that are viewed as abusive—loans that can be obtained at little or no interest and never have to be repaid for example—and I have not been able to do it. There are loan properties and there are interest-free properties to some of these products, but none of them have all the abusive features that were in the ads in the papers.

I am just wondering if this panel could articulate for me what, and perhaps you have done this already, and I am sorry if I am going to make you reiterate them, but where are those perceived abuses?

Mr. SCHWEIKER. I would say that where we are trying to target our focus, Congressman, is on products that basically are advertised, marketed, and bought as an investment product. That is our concern. And the proposal, the concept that we are working on very fairly focuses on it.

It doesn't kill single premium products. It would tax single premium products that basically are used as an investment. Now, there was some earlier testimony that my colleague Senator Irons said that policy loans had been made, I think, on about 7 percent of the policies involved. So all we are trying to do with our approach is to target policies where that investment use occurs and not kill, or destroy, or change other things in sight.

Mr. McGRATH. Would you consider a loan against a premium of 7 percent to be abusive?

Mr. SCHWEIKER. Well, I think that it is a matter of whether or not the investment feature of a policy outweighs the life insurance feature. We obviously believe in permanent life insurance, and we believe in the concept of building up cash values as part of such policies.

When it is not used for that purpose, is our concern. It is very difficult to pin down where this fine line is. I wouldn't disagree at all with the point you make. That is one of our difficulties as an industry, trying to find where that fine line is, where you cross the threshold. I don't have a quick and easy answer for it.

Mr. McGRATH. Are you not somewhat skeptical or afraid that any intrusion into the two properties that are being discussed as applicable to life products, that being policy loans and taxation of distributions, will eventually result in the taxation of inside build-up.

Isn't that a problem for you?

Mr. SCHWEIKER. We certainly are concerned, and I concur with your point. That is one of the reasons that we would limit any proposal to change the distribution rules by using a definition in terms of single premium. I know my colleagues here, who we try to work closely with, have great concerns about it. I will let them speak to it.

Mr. McGRATH. What would happen to this industry if these two properties of the product, the loan policy and inside build up were taxes as outlined in the Stark-Gradison proposal?

Mr. SCHWEIKER. No question, such a change in tax laws would destroy the industry. As I mentioned in my earlier testimony, some 68 percent of the people who have all permanent policies—I am not talking about single premium—have $30,000 or less of income.

So, in fact, such a bill would deny the hardest hit unit of our society the right to have resources to borrow to meet emergencies that come up, where the small home owner or small renter, or small income earner would be utterly devastated by the emergency. No question.

Mr. McGRATH. Well, if there are abuses out there and they can be articulated and demonstrated, then I am all for doing away with them. At the same time, I am wary of proposals that would kill an entire industry, with its millions of employees and multibillion dollars of investments.

Thank you.

Mr. FLIPPO. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman. I was on the Stark-Moore subcommittee when several years ago we labored a long time on the questions of what is life insurance, how do we tax life insurance, how do we tax insurance companies, and we thought that we had dealt with most of those issues.

I discovered, having worked in a number of areas that were very complex, that there is nothing more arcane or complex than taxation of insurance companies and the whole menu of products that your industry offers to the public.

The reason we are here today, I would guess, is that most of us in Congress passed tax reform legislation and then bought newspapers for a 25 cent fee and opened the papers to discover that there were some firms out there advertising the last great tax shelter left available to the American public.

Members of Congress who saw that said, I wonder what that was. This looks almost too good to be true, and anything that is too good to be true, generally, isn't true. It raised the whole question here about what are they talking about? What is this last great tax shelter? There is an old saying, "The skunk generally creates its own publicity." In this instance the publicity that has been created, I think, has raised a lot of questions about what are the problems and what was left undone with the Stark-Moore subcommittee, if anything.

I want to follow up on what Mr. McGrath was asking, what specifically is the problem? Every time we think there is a problem somewhere, our tendency is to try and fix everything along the way to find that problem. I would prefer that our approach here would be to analyze what the problem is as specifically as we can analyze it, and try and craft a solution to that that is the best solution possible as a matter of public policy.

I am not sure I heard a good response to Mr. McGrath's question. Mr. Irons, what precisely is the problem as you see it?

Mr. **Irons**. Our feeling, if I could phrase it in one area, is that there is not enough death benefit associated with the money going into the contract. I will put my other hat on, if I could for a minute.

I am a State legislator, and I know well that when we draft laws, we try every bit we can to understand and yet, when we are through, we really find out that there is one aspect that needed a little more tightening like a bolt on a machine.

If I could, Congressman, I would say that is really what is left undone here, is we found one or two bolts that need to be tightened a little tighter and what we need to do is make life insurance more death benefit-oriented and investment-oriented. Life insurance was never intended to be a pure investment. What was done so well to define life insurance in section 7702 was done well, but it isn't perfect.

Mr. **Dorgan**. Mr. Irons, you have told me we have got a couple of bolts left to tighten. Can you describe your solution to do that? Can you describe for me the support for your solution? You are testifying on behalf of NALU, where is the support outside of your organization? Is it broader than that?

Mr. **Irons**. Yes. I believe it is broader than that.

Mr. **Dorgan**. Can you describe the support for me?

Mr. **Irons**. Can Mr. Regan explain in detail how the bolts tighten? I think that will tell you how the support occurs?

Mr. **William Regan**. I think the three key areas that we are trying to tighten up: the level of investment that can be made in a policy's early years; the appropriate charges for mortality in the early years; and the appropriate expense load that should be allowed in the early years. While current law seemed appropriate prior to tax reform, the changes made in tax reform make current law governing life insurance investment levels seem too generous when compared to the tax treatment of other investments. Current law viewed retrospectively, allows far more tax-favored investment orientation than anyone thought would be possible. As a result, some tightening is needed to assure continued appropriate tax treatment for those who need and want to purchase death protection oriented life insurance.

The areas of the needed tightening specifically are in the mortality and expense area, in addition to the fact that it is possible with the current levels of investment returns on a single pay policy to just build up a lot of investment income that you don't need to maintain the death benefit. We agree with the ACLI that the problem is the heavily investment oriented product and our members are very concerned that because of that perceived abuse, which we recognize as an abuse, that traditional taxing of life insurance will be threatened.

Our policyholders—and our 135,000 members reflect many hundreds of thousands of policy holders—would certainly be done a great disservice by that. We are sensitive to our policyholders' needs.

Mr. DORGAN. Mr. Schweiker, there are members of your industry or companies in the industry who will likely testify today that will represent the advertising to have been, perhaps, misleading or overly optimistic or whatever terms they might used, but that in fact, there is nothing abusive about the single premium policies.

How would you respond to that argument?

Mr. SCHWEIKER. Well, I am not sure which companies—we have several companies testifying, so I am not quite sure which one you are referring to. I will be glad to answer the question generally.

Mr. DORGAN. I didn't mean member companies. I am talking about insurance companies.

Mr. SCHWEIKER. You asked about companies that were coming to testify. Would you rephrase the question again, Congressman?

Mr. DORGAN. Well, some insurance companies would take the position that while there was some advertising that was over promising or, perhaps, abusive or false advertising, in fact the single premium insurance policies that are sold are not in themselves abusive. How would you respond to that?

Mr. SCHWEIKER. Well, it goes back to the earlier part of your question too. As I understand the Congress' concept over the years, it has basically felt that the social value of the life insurance product was the reason for its current tax treatment. That concept has been proven again and again, and I think the last tax act reaffirmed it. When we are getting into the area of criticism and concern is when it becomes investment oriented.

So when these products are advertised, promoted, marketed, and bought as an investment, it seems to me that begins to undermine the very concept that Congress and the subcommittee had when they gave the social value of life insurance protection a high priority.

That is where we tried to target our response to dealing with the problem.

Mr. DORGAN. Finally, let me say that I think that 4 years ago when we had these lengthy discussions about the insurance industry, I think Congressman Flippo was part of those discussions as well as several of others of us on this subcommittee, we concluded then having reviewed it in some detail that the traditional tax treatment of inside buildup, should be retained. I think the point that has been made several times this morning is an important point, that is to the extent that there are some who would move toward the margin and use the advertisements that we have seen, that actually captivated our attention here in Congress, it does lead to inquiries in Congress that once again go at the basic question of tax free inside build up.

I don't think revisiting that every year is in your interest or ours. I think we need to make some long term judgments that contain predictablity and certainty for you and the American people with respect to the taxation of these insurance products.

Mr. FLIPPO. Mr. Gregg.

Mr. GREGG. I was wondering if anyone on the panel has a number—either by guess or actual study—as to what percentage of the money going into those products, would continue to go into other forms of life insurance products if the single premium products were not available in the present form, were they limited to the form you are presenting, Senator Irons.

Mr. IRONS. I had trouble with the number a few minutes ago. I will guess. I think a tremendous amount of this would disappear. I think the obvious answer to that, Congressman, is because a great percentage of this is being sold by the stockholders, not being sold by the traditional life insurance agents.

That has grown in the recent past because many of us work across-the-board and have a client who a stockbroker is approaching and saying here, and as long as the client understands the facts and makes the decision that that is where they want to put the investment dollars and the law allows that, as an investment adviser, you are put in a difficult position to say you should not do that.

That is why we are here today, to ask you to put death benefit back into the life insurance contract, single premium contract.

Mr. GREGG. Do you have any idea of where those investment proceeds are coming from that are going into the single premium investments now? Are they coming out of other investments? IRA accounts for example?

Any study that reflects that?

Mr. IRONS. I think the majority of the sales are from CDs. I would not expect that the money is coming from IRAs because most of them are subject to a penalty to take money out. It is primarily disintermediation. The difference now, as opposed to the annuities of the 1982 timeframe has to do with the tax shelter, not the tax buildup, but the tax-deferred buildup. The majority of the money is CD money, I believe. I have no study on that, but working in the market, that is where I see the activity coming from.

Mr. GREGG. Are there any studies going on relative to those two numbers?

Mr. SCHWEIKER. It is a quite legitimate question, Congressman. It is one I have asked our associates and companies. It is really a very difficult figure to come up with in terms of how to pin down the sources of such funds. I am sure some of it, in addition to what the Senator said, I am sure some of the money going into the single premium life policies is in lieu of the purchase of annuities or other life insurance products.

It is really difficult. I honestly cannot give you a quantified answer that would mean anything.

Mr. **Gregg**. What percentage of the single premium policies that are being bought now are being borrowed against?

Mr. **Schweiker**. A little over 7 percent, I believe.

Mr. **Gregg**. If the money is coming out of CDs generally, and CDs generally being very liquid, do we end up with a longer savings vehicle?

Mr. **Irons**. I caution—that is what I meant about the 7 percent number getting me in trouble. I caution you about that 7 percent number. That is a number that is early in the history of this product market.

I would not extrapolate too much from that 7 percent figure. I personally would not. I would caution you and the committee not to.

We put it in to show what we can document at this point.

Mr. **Gregg**. Increase the number by 100. Make it 70 percent. Aren't you still into vehicles that are creating longer investment terms than a CD, cash equivalent fund? Aren't you creating a more stable savings base than CDs if this money is coming out of cash equivalents and going into something like that?

Mr. **Irons**. I am not sure I fully understand. My reaction would be you are not because the money coming out is part of being consumed rather than accumulated. Just off the top of my head, I do not see it that way.

I don't think that is the way most of it is sold.

Mr. **Minck**. The answer, I think, will depend upon the perceptions of the companies as to how much borrowing activity there will be. It is certainly true that you can invest such funds in longer term loans than with the CD where the money is scheduled to go out in 6 months to a year.

But again, it is very early—it might turn out that there is a lot of borrowing activity which has not shown up yet.

Mr. **Pike**. If you are talking about the life insurance contracts sold in the 1960s, then there is a good chance that that money is invested in long-term investments. In recent years, the growth in life insurance sales has been in variable life insurance contracts in which investors get to decide what sort of investment their money will be invested in.

It could be invested in 6-month Treasury bills. It could be in real estate. It could be in common stock. There is no assurance that it will be invested in long-term bonds or investments.

In addition, the company has to be aware that the policy holder has a right to obtain the cash value of the contract at any time. This means that the cash value is a liquid investment to the policyholder in much the same way that a 5-year CD is liquid and that the company has to beware that a run on the bank could cause big problems.

In the late seventies and early eighties, many life insurance companies were teetering on the brink of insolvency because there was so much demand for policy loans.

Fortunately, that has passed. But the liquidity of the life insurance contract is, in terms of liquidity, indistinguishable from a multiyear CD.

Mr. **Gregg**. I guess that is the issue I am trying to get to. If from a tax policy point of view we were trying to establish incentives to save in vehicles which create a more stable capital investment atmosphere and thus longer term vehicles, what are we losing by having these premiums going from cash equivalents into insurance contracts which may be basically liquid but are less liquid probably than the investment the premiums are coming from?

Mr. **Pike**. Again, we should compare the increased savings that is generated and compare that to the tax revenue we lose to encourage that savings. The data I have—and I don't have great data on this—suggests that what you get is savings that switches from one place to another. With the policy loan provisions and other withdrawal rights, there is no assurance that the dollars are going to stay there any longer.

I think it is hard to say there is any long-term savings increase, but just a shifting as to which financial intermediary, banks or life insurance companies, would be doing the investing for the owner of the assets.

Mr. **Gregg**. That is just your expert opinion?

Mr. **Pike**. It is my opinion and that of other people I have read, such as former Deputy Assistant Secretary McLure.

Mr. **Gregg**. Thank you.

Mr. **Flippo**. Mr. Stark.

Mr. **Stark**. I want to thank the panel and welcome everyone back. I worked with all of you. I appreciate your testimony.

Mr. Schweiker, is it a fair assumption—I haven't found a statistic in your fact book or anything like that—that aggregates—the total cash value that is abroad in the land at this moment.

My guess is that there is $200 billion in ordinary reserves. That is a figure I can pick out someplace. Therefore, cash value is somewhat less than that. I am going to guess it is between $150 and $250 billion. Is that a ball park? Anybody?

I wanted to quantify what is out there.

Mr. **Minck**. You are not far off on that. We can give you a figure for ordinary life insurance reserves—they amounted to about $240 billion at the end of last year.

Mr. **Stark**. The thing I come back to all of you, it is not a matter of concern, because I think the market and the Treasury will take care of this, but on the $150 billion—let us say there is 6 percent, which is damning your industry by faint praise.

You are earning nine or $10 billion a year on inside buildup that we are not now taxing. Professor Pike makes the case that if that is there, that inside buildup is encouraging people to acquire more death benefits and is probably a good social cause. Probably not much of that is going to buy death benefits.

We can guess what the lost income is.

The thing that I see—and I am sure that Mr. Gradison shared my feeling, and I know that what others see is that in 2 short years—2 short years—10 percent or more of that cash value has been just built up in one product.

If you project that—and I am not sure that is a fair projection, because if it is all disintermediation, this thing may have a very short life. The stockbrokers may run out of dollars to switch from one account to the other and you guys may win. There would be no need to legislate.

This would have been an interesting exercise. I don't think anybody knows that.

But I do think that the industry is not as together as ACL would like or they would hope and as a matter of fact as we might like. In the absence of the industry being together, it will probably be difficult to get the best solution.

We will get a solution that tilts more toward whoever has the more political pressure they can bring to bear and we may push it off.

I do see—and I talked about this—that the real issue is not so much single premium. Mr. Irons touched on it. It is there is some feeling the stockbrokers are getting into the arena and muddying the waters in the opinion of some. Certainly not selling death benefit or death protection, income protection because of death with the same degree of professional approach that the CLU and their training would have them sell it.

There are others who might argue that that is all for the better, that through the brokers and their 2 percent commissions, people will buy a hell of a lot more decreasing term. I can call a spokesperson myself.

At some point, you are talking about too much investment. That is what I guess I am getting at. All insurance with perhaps the exception of the testimony we will hear later from Williams, is basically urged upon the public as an investment. You want people to own insurance.

You don't want them to rent it like term, for the most part.

The only issue is do we follow Mr. Pike's advice and say why—what is that investment for relative to the purchaser of the product. Is that investment there to encourage them to keep their life—their death benefit protection? Or is it there to save for college and all these other things?

That has always been kind of an ancillary option, ancillary feature, held out.

You have this. If you need it before you do, it is called living insurance. You have all probably given the pitch better than I can.

Use it to educate a child, a grandchild, provide for a lot of things. It is all invested. I think you would all agree. If anyone thinks it is not all investment, raise your hand.

Largely, the argument is who is selling it and what is that investment income that is being sheltered used for? That is what this whole debate is. I have a hunch if we argue too long—we, being the folks at the table—you are going to find that somebody else is going to sneak in and take the cheese out of the trap.

Merrill Lynch is coming close to doing that. Witness that in two short years they are now selling what it has taken the ordinary purveyors a long time to get up to. They are $10 million in 5 or 6 years.

I just suggest if we could get together as between Mr. Irons, Mr. Regan, Mr. Pike and say I tend to not like the definitional idea because it still can't probably be gained, a little bit.

We may be back in a few years trying to redecide. I am not sure that we can do it just on penalties. My hope would be that we could give some incentive for protection as Professor Pike would encourage and then say whatever else is in these contracts in terms of investments ought to have somewhat the same playing field as other investment opportunities and then you have got a package that you can sell fairly well and we can go on to other things.

I don't know whether we can do that. There is no new rules. We exhausted them all. Your industry has come up with different ways to keep the lid on the box. I just hope that you will continue to work with us and be as generous as you have with your time and as patient with us as we try to figure out the way it will get the majority of votes in the industry.

My time is up.

Mr. **Flippo.** Mr. Irons.

Mr. **Irons.** I wanted to respond to that, if I could, Congressman. I want to be the one who says if it is sold as an investment, that is incorrect. Life insurance has an investment element, but it is not primarily an investment. Nor is it usually sold primarily as an investment.

To say all life insurance is primarily an investment is not correct; it is not the truth, Congressman.

The point is that someone who says rent insurance is using a glib term. Term insurance is a very proper vehicle for a short term need.

It's like a home mortgage loan. It provides housing. However, it is not improper for someone to go to the bank—the people who have the equity in the home—and ask to borrow that equity, and pay interest on the loan. Similarly, the cash value in the policy belongs to the insurance company, but it is perfectly proper for the policyholder to ask to borrow against the cash value, and to pay interest on the loan.

You say that stockbrokers are coming on to our turf. But this is not a turf battle. It's fairness stockbrokers are selling an investment called single premium life insurance. As long as everyone knows it's an investment, it's time for investment sales people to sell it. But if it's life insurance it should be sold as life insurance, not as investment. Life insurance serves a social purpose, a very important social purpose.

That means that if you need more revenues you should look elsewhere for it. If you don't, across the country, the hundreds of millions owners of life insurance contracts will lose life insurance protection. If that happens, you will be looking for a lot more revenues in the future in order to fill the needs these particular policies fill.

Mr. **Flippo.** We thank the panel for your testimony today. It has been very, very helpful.

Mr. **Flippo.** This is the seventh inning. I think we are impressed with the patience and capability and capacity of this audience and their attention to this subject. I can only assume it is a subject that wonderfully concentrates the mind.

Our next panel is Robert Sharp, president and chief executive officer, Keystone Provident Life Insurance Co.; Harry Edwards, president and chief executive officer, National Western Life Insurance Co.; Donald Alexander, Cadwalader, Wickersham & Taft; Will Davis, Heath, Davis and McCalla; Gordon Oakes, president and chief executive officer, Monarch Capital Corp.; and William Clark, chief executive officer, Massachusetts Mutual Life Insurance Co.

STATEMENT OF ROBERT G. SHARP, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KEYSTONE PROVIDENT LIFE INSURANCE CO. AND HARRY L. EDWARDS, CHIEF EXECUTIVE OFFICER, NATIONAL WESTERN LIFE INSURANCE CO., ON BEHALF OF THE COMMITTEE OF LIFE INSURERS, ACCOMPANIED BY DONALD C. ALEXANDER, COUNSEL

Mr. **Sharp.** I am Robert Sharp. I come from Boston. With me is Harry Edwards of Austin, Tex., and Don Alexander of the District. We are here today on behalf of the Committee of Life Insurers.

The Committee of Life Insurers is an ad hoc group of 22 life insurance companies which sell a wide variety of life and health insurance products, including single premium life insurance policies. The committee was organized to monitor tax legislative developments affecting life insurance contracts, and single premium life insurance contracts in particular, and to convey the views of the member companies to the Congress. The committee's member companies issued approximately 50 percent of the single premium life insurance sold in 1987. A list of the companies which comprise the Committee of Life Insurers is appended to the prepared statement.

Mr. Chairman, the Committee of Life Insurers appreciates the opportunity to appear before this subcommittee and to present its views with respect to the Federal income tax treatment of life insurance contracts.

During the last year an increasing amount of attention has been focused on the tax treatment of life insurance policies. Certainly some advertisements have encouraged the purchase of single premium life insurance policies principally for investment returns rather than death benefits.

In our view, these advertisements have caused a misunderstanding of the nature and uses of single premium life insurance policies. We think it is important that these misunderstandings be corrected. Single premium policies are an important form of permanent life insurance. Their Federal income tax treatment should not be altered based on misconceptions. Accordingly, I would like to spend a few minutes sharing with you some facts about single premium life.

These facts are based upon data we have collected from 24 companies which sold approximately 75 percent of the single premium life insurance in the first half of 1987. To begin with, what is single premium life insurance and who buys it?

Let me emphasize first and foremost, single premium life is a life insurance contract. It is a permanent insurance contract. Like all other life insurance policies, single premium life provides a death benefit substantially greater than the premium paid for the policy.

Based upon our survey, the average death benefit of a single premium life policy is approximately $81,000 compared to $60,000 for other forms of ordinary life insurance. As the name suggests, the only feature which distinguishes single premium life from any other type of permanent insurance is that it is purchased with one premium payment, rather than a series of premium payments.

Unfortunately, some advertisements seem to have fostered the impression that single premium life is the tax shelter of choice for wealthy young professionals. The facts are that approximately 25 percent of single premium policies are purchased by individuals between the ages of 50 and 59, and 33 percent are purchased by individuals between the ages of 60 and 69. These purchasers are not wealthy, they are middle class and, for example, in a survey by one company of its single premium policyholders, the average income of the policy holder was $44,000, and 80 percent of the policyholders surveyed earned less than $60,000 annually.

More than half of the purchasers of single premium life are over age 50. For such individuals, a single premium life policy offers substantial death protection and liquidity from one premium payment.

In view of these facts, we do not believe that the tax definition of life insurance should be amended to exclude single premium policies. Consequently, we think the adoption of a proposal such as that advocated by the NALU would be a serious mistake.

If the NALU proposal were adopted, a life insurance policy which qualified as life insurance for tax purposes when purchased would lose its qualified status if an individual, for any reason, were unable to continue premium payments and the policy lapsed into paid up coverage with reduced benefits, as required by State law.

The NALU proposal also regulates on a de facto basis the charges a life insurance company can impose for the mortality risks it assumes as well as the company's expenses. Adoption of such regulation would be unprecedented, and unwarranted.

As long as permanent life insurance has a savings element which is not subject to current taxation, some person will undoubtedly tout that product as a tax shelter. Simply because this characterization has been applied to single premium life policies does not mean that such policies are abusive and their sales should be ended.

Accordingly, we urge this subcommittee to reject not only the NALU proposal but any other definitional change that would result in single premium life not qualifying as life insurance for Federal tax purposes.

Finally, we would like to comment briefly on policy loans. We recognize that a number of advertisements for single premium life have highlighted the right of a policyholder to borrow against the policy's cash value. Again, however, a significant gap exists between what the ads say and what policyholders actually do.

Based upon our survey, very few policyholders borrow from their single premium life policies. Only 8.4 percent in our survey of such policies have a policy loan and in addition, those policyholders have not borrowed large sums—3.7 percent of the cash values of single premium life have been borrowed.

In conclusion, we ask each of you to judge single premium life on the basis of the facts and not on imagery created by advertisements. Single premium life provides the same social function as other forms of permanent life insurance in that it offers substantial death benefits combined with long-term savings. If this subcommittee nevertheless concludes that some change in the Federal income tax treatment of life insurance or policy loans is warranted, we would be pleased to cooperate with you and your staff. Hopefully, out of such an effort we could alleviate the subcommittee's concerns without discouraging the purchase of any form of life insurance. Thank you for listening.

Mr. **Flippo**. Thank you, Mr. Sharp.

We are pleased to have with us the distinguished chairman of the Subcommittee on Oversight, the gentleman from Texas, Mr. Pickle.

Mr. **Pickle**. Thank you, Mr. Chairman.

I have asked for the time to introduce to you my friend Harry Edwards who is president of the National Western Life Insurance Co. of Austin, Tex.

I have worked with this gentleman and his company, been to his offices, visited with his officers and salespeople. He is one of the most respected experts in the life insurance field in Texas and is as highly respected in my city. I noticed, Mr. Chairman, Mr. Will Davis, an attorney from Austin was scheduled to testify. I believe he was held up in court.

Harry Edwards and I have been friends forever so I want to welcome Mr. Edwards and tell you he certainly has my confidence and my respect as an insurance man. Glad to have you, Mr. Edwards.

Mr. **Flippo**. Mr. Edwards, we would be delighted to receive your testimony at this time.

Mr. **Edwards**. My testimony is in the form of statistics involving my own company. These are very brief statistics. They apply to a specific company, a specific time and looking at very specific people. These statistics were gleaned directly from our policy files.

As of December 31, 1987, National Western Life Insurance Company had in force 5,744 single premium life insurance policies. Of that number of policyholders, 86.6 percent of them had annual incomes of $50,000 or less. These are statistics contained directly on the applications for their insurance policies.

As a matter of fact, 33.6 percent of our policyholders who own single premium life policies have annual incomes of $25,000 or less. I give you those numbers to show that, at least from our specific point of view, this is not a product that is bought by and is available only to rich people.

Conversely, and these numbers need to be known too, 6.4 percent of all our policyholders make in excess of $100,000. So there are some people in there who have more than adequate incomes.

From an employment standpoint, a great number of our policyholders are retired school teachers and current school employees. That is the market we target; so 46 percent of all our policyholders are either retired individuals or active school employees.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF ROBERT G. SHARP AND HARRY L. EDWARDS, ACCOMPANIED BY DONALD C. ALEXANDER AND WILL D. DAVIS, ON BEHALF OF THE COMMITTEE OF LIFE INSURERS

Mr. Chairman and members of the Subcommittee: My name is Robert Sharp. I am President and Chief Executive Officer of Keystone Provident Life Insurance Company. With me is Harry Edwards, President and Chief Operating Officer of National Western Life Insurance Company, Donald C. Alexander of the law firm of Cadwalader, Wickersham and Taft and Will Davis of the law firm of Heath, Davis and McCalla, P.C. We are here today on behalf of the Committee of Life Insurers.

The Committee of Life Insurers is an ad hoc group of 22 life insurance companies which sell a wide variety of life and health insurance products, including single premium life insurance policies. The Committee was organized to monitor tax legislative developments affecting life insurance contracts, and single premium life insurance contracts in particular, and to convey the views of the member companies to the Congress. The Committee's member companies issued approximately 50 percent of the single premium life insurance sold in 1987. A list of the companies which comprise the Committee of Life Insurers is appended to this statement.

I. Introduction

Mr. Chairman, the Committee of Life Insurers appreciates the opportunity to appear before this Subcommittee and to present its views with respect to the Federal income tax treatment of life insurance contracts. In the last several years Congress, and this Subcommittee in particular, has extensively considered the Federal income tax treatment of life insurance contracts. This thoughtful and careful review resulted first in the enactment in 1982 of an Internal Revenue Code provision assuring that universal life insurance policies would be treated as life insurance contracts for Federal income tax purposes. Then, in 1984, Congress enacted a Federal tax definition of a life insurance contract, followed in 1986 by an amendment to that definition which altered the traditional treatment of distributions under life insurance contracts. In 1986, Congress also expressly rejected the President's proposal to tax the inside buildup of life insurance contracts. Taken together, these decisions reflected the considered judgment of this Subcommittee and the Congress that the income tax treatment of life insurance policyholders was, as recently as 1986, correct.

During the last year, however, an increasing amount of attention has again been focused on the tax treatment of life insurance policies. Much of this attention has been directed toward finding a "solution" to what to us appears to be an unclearly defined "problem." For example, we have seen the following "solutions" offered.

Joint Committee on Taxation Staff: In June, 1987, the *Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means (JCS-17-87), June 25, 1987* (the "*Description of Possible Options*") suggested that (1) the inside buildup of life insurance policies could be included in the income of the policyholder; (2) the definition of life insurance could be modified to provide that "significantly investment-oriented life insurance policies such as single-premium life insurance policies" not be treated as life insurance policies for Federal income tax purposes; (3) distributions from life insurance policies prior to the death of the insured could be treated as coming first from the inside buildup of the policy, *i.e.*, taxed on an income first basis; or (4) loans under life insurance policies could be treated as distributions under the policy.

Congressmen Stark and Gradison: H.R. 3441, introduced last October, would (1) treat loans from a life insurance policy as distributions, (2) include distributions in income on an income first basis to the extent of the gain under the policy, and (3) impose a penalty tax of 10 percent of the amount of any distribution includible in income, except in certain situations.

The General Accounting Office: Last October, the GAO suggested that loans from single premium life insurance policies could be treated as distributions, with distributions includible in income on an income first basis. Alternatively, the GAO suggested that the definition of a life insurance contract could be amended to provide that the section 7702(d) "cash value corridor" would be applied to death benefits net of any outstanding policy loans.

The National Association of Underwriters: NALU has proposed that a new premium payment requirement be grafted onto section 7702. Under this proposal, a life insurance policy paid for with fewer than five level premiums would not be treated as life insurance for federal tax purposes.

Ad Hoc Proposals: Others interested in the Federal tax treatment of life insurance contracts have proposed that the distribution rules of HR 3441 (or some version thereof) be applied to a limited class of life insurance policies, e.g., a policy paid for with fewer than five level premiums.

Why have these various proposals for change in the treatment of life insurance policies been made? And why has this Subcommittee, as stated in the notice for this hearing, become "concerned that the present statutory definition may not be curtailing the purchase of life insurance principally as an investment or as funding for consumer purposes rather than, as intended in the 1984 legislation, a means to provide death benefits for dependents?"

We believe that these proposals, and this Subcommittee's concerns, have developed as a result of the growth in purchases of single premium life insurance policies, combined with advertisements emphasizing, and in some cases mischaracterizing, the tax-favored savings aspects of such policies. Congressman Stark has been quite frank in this regard. He has stated that he introduced HR 3441 "because of the explosive growth in single premium whole life policies. . . ." and he has pointed to advertisements which "describe the many tax shelter features of single premium whole life policies." Cong. Rec. Oct. 22, 1987, H8953.

This concern is understandable. The current income tax treatment of life insurance policies is based on the sound public policy of encouraging individuals to provide for their family's future financial security. Certainly, some advertisements have encouraged the purchase of single premium life insurance policies principally for investment returns rather than death benefits. In our view, these advertisements have caused a misunderstanding of the nature and uses of single premium life insurance. We think it important that these misunderstandings be corrected. Moreover, we respectfully submit that if the true nature and uses of single premium life insurance policies are understood, this Subcommittee will conclude that the tax treatment of such policies -- as well as other forms of permanent life insurance -- is correct and that no changes should be made in that treatment.

II. What is single premium life insurance?

Some people seem to think that a single premium life insurance policy is a recently developed investment vehicle, the income tax treatment of which Congress has not adequately considered. We believe they are mistaken. The fact is that single premium life insurance is a traditional and important form of life insurance, the income tax treatment of which was thoroughly considered by Congress in 1984.

Single premium life insurance policies have been available in the United States for decades. Like all other life insurance policies, a single premium life insurance policy provides a death benefit substantially greater than the premium paid for the policy, thereby protecting the insured's beneficiary against financial loss from premature death. For example, the average premium for a single premium life insurance policy is approximately $29,600, while the average death benefit is approximately $81,000. 1/ In comparison, the average ordinary life insurance policy sold in the United States in 1986 had a death benefit of approximately $60,000.

As its name suggests, the feature which distinguishes a single premium life insurance policy from any other type of permanent life insurance policy is that it is purchased with one premium payment, rather than a series of premium payments extending over a period of years. Aside from the mode of premium payment, however, a single premium life insurance policy is essentially identical to any other form of permanent life insurance contract. Thus, first and foremost, a single premium life insurance policy guarantees that the insured's beneficiary will receive a substantial death benefit whenever the insured dies.

In addition, like all other permanent life insurance contracts, a single premium life insurance policy has a cash surrender value which is mandated by the Standard Nonforfeiture Law, a uniform law which is in effect in all states. In addition to requiring that permanent life insurance policies provide a cash surrender value, the Standard Nonforfeiture Law requires that a policyholder who discontinues making premium payments have the option to purchase extended term insurance or to use the contract's cash value as a single premium to purchase a paid-up life insurance policy in a lower amount. That is to say, pursuant to uniform state law all permanent life insurance policies may be converted at the policyholder's option into a single premium life insurance policy.

This is not surprising. If the expenses associated with the sale and administration (the "loading") of a life insurance policy are set aside, all forms of permanent life insurance policies are essentially the equivalent, on a present value basis, of a single premium life insurance policy. Whether an individual purchases a limited pay life insurance contract with level annual premiums payable for a fixed number of years, an ordinary life insurance contract with level annual premiums payable for life, or a universal life insurance contract with flexible premium payments, the present value of the net premium payments (the premiums without loading) for a given amount of death benefit is equal to the net

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1/ This data is based on a survey of 24 companies, which issued approximately three-quarters of the single premium life insurance policies issued in 1987 (based on premiums). The survey was conducted by the Committee of Life Insurers and the data reflects sales through June 30, 1987.

single premium (the single premium without loading) under a single premium life insurance policy providing the same amount of death benefit.

Single premium life insurance policies, like all other permanent life insurance policies, also have a policy loan provision mandated by state law. The policy loan provision usually provides that the life insurance company will lend the policyowner an amount up to the cash surrender value of the policy, that the company can charge interest on that loan at a specified rate (which is limited by state law but may vary in accordance with a formula or an index), and that the policyowner may repay the loan in whole or in part at any time. If, however, the policyowner has not repaid the loan at the time the insured dies, the amount of the death benefit proceeds payable to the insured's beneficiary will be reduced by the amount of the outstanding loan and any unpaid interest.

In sum, single premium life insurance policies generally differ from other forms of permanent life insurance only in that they are purchased with one premium payment. As discussed in the next section of our statement, this difference can be quite beneficial to a purchaser.

III. Who purchases single premium life insurance policies and for what purposes?

Unfortunately, some advertisements seem to have fostered the impression that single premium life insurance policies are the tax shelter of choice for wealthy, young professionals. As is often the case, however, there is a large gap between the picture created by Madison Avenue and the facts. Contrary to perceptions, approximately one-quarter of single premium policies are purchased by individuals between the ages of 50 and 59. Another one-third are purchased by individuals between the ages of 60 and 69. Nor are these purchasers wealthy; rather, they are middle class. For example, in a survey by one company of 1445 of its single premium policyholders, the average income of the policyholders was $44,000, and 80 percent of those policyholders earned less than $60,000 a year.

These individuals are purchasing single premium life insurance policies for essentially the same reasons as other forms of permanent life insurance, including the guarantee of lifetime insurance protection combined with long term savings. These reasons have traditionally been recognized by Congress as worthy goals deserving of encouragement. The Description of Possible Options acknowledged this and stated (at page 226) both that "[e]ncouraging people with disposable income to provide financially for their dependents in the event of death is an important social policy that should be encouraged . . ." and that "[w]hole life insurance . . . provide[s] a vehicle by which individuals who do not participate in a qualified pension plan may fund adequate amounts of future retirement income and security for their dependents on a tax-favored basis."

The single premium payment method offers particular advantages to purchasers. For example, if an individual aged 45 were to purchase a single premium life insurance policy with a death benefit of $100,000, the single premium paid for the policy would be substantially less than the sum of the 50 annual premiums the same individual would pay for a whole life insurance contract also with a death benefit of $100,000. Indeed, for any given amount of death benefit, the total cost of a permanent life insurance policy will increase as the number of required premiums increases and as the duration over which the premiums are paid lengthens.

Obviously, much of this increased cost is attributable to the fact that in the case of the whole life insurance contract the individual has the benefit of the use of his money prior to each premium payment. The fact remains, however, that purchase of a single premium life insurance policy rather than a policy with annual premiums payable for a lengthy period is analogous to making a cash purchase rather than an installment purchase -- the purchaser pays a smaller amount for his or her purchase. It is also noteworthy that a portion of the increased cost of a multi-premium policy is attributable to the higher expenses incurred by a life insurance company in connection with multi-premium life insurance policies. For example, the commmissions paid on a single premium life insurance policy by a life insurance company are typically 3 to 5 percent of the premium. In contrast, the commissions paid on multi-premium policies, while subject to substantial variation among companies, are often in the range of 8 to 9 percent of the premiums (computed on a present value basis.)

Another advantage of purchasing a permanent life insurance policy with a single premium is that the owner obtains guaranteed permanent (or "whole") life insurance protection in a fixed amount without the necessity of any further premium payments. In contrast, if a permanent life insurance policy is purchased on other than a single premium basis, the policy will lapse if future premiums are not paid. (In that event, if the policy has any cash value, the cash value will be applied either to purchase a single premium paid-up policy in a lower amount or to purchase a single premium term policy for a period shorter than the whole of life.)

The purchaser of a single premium life insurance contract, like the purchaser of any other life insurance contract, obtains a substantial death benefit and must incur mortality charges for this insurance benefit. As a consequence, the earnings on the savings element of a permanent life insurance contract are necessarily reduced by the mortality costs assessed by the insurance company. In addition, an applicant for a single premium life insurance policy must establish that he or she is insurable. No life insurance company will issue a single premium life insurance policy without requiring the applicant to furnish medical information (either by answering a medical questionnaire or by taking a medical examination) and without establishing that the beneficiary has an insurable interest in the insured. Virtually all life insurance companies then verify the applicant's medical history with the Medical Information Bureau.

Like all other forms of permanent life insurance, a single premium life insurance policy provides a savings element through the annual increments to the policy's cash surrender value. The presence of this mandatory savings feature has traditionally been one of the reasons that individuals purchase permanent life insurance rather than term life insurance, and historically it is one of the reasons that some persons have purchased single premium life insurance policies. For example, more than half of the purchasers of single premium life insurance policies are over age 50. For such individuals, a single premium life insurance policy offers substantial income protection and estate liquidity from a single purchase payment. In addition, an older person seeking life insurance protection will find level premium or increasing premium coverage to be much more expensive in the long run -- perhaps prohibitively so -- whereas single premium based coverage will present itself as affordably priced. Furthermore, based on company surveys of their policyholders, many such individuals purchase single premium life insurance policies to provide retirement income. For example, the proceeds of the policy can be used to purchase a life annuity.

We cannot state that no purchaser of a single premium life insurance policy has been motivated by the desire to use his or her policy as a tax-advantaged savings vehicle for consumer purchases. Indeed, we recognize that some companies (and some financial columnists) have emphasized just such uses. It should also be recognized, however, that to our knowledge no evidence exists that policies are actually being widely used for such purposes. Moreover, irrespective of his or her motivation, an individual who purchases an average size policy and pays the average single premium of $29,600 purchases a substantial amount of death benefit protection -- on average, $81,000.

IV. Is single premium life insurance too "investment oriented?"

In 1983 and 1984, this Subcommittee intensively studied the Federal income tax treatment of life insurance contracts. That study arose from concerns that some life insurance products were overly investment oriented -- in that they contained large cash values relative to the amount of insurance protection -- and that the traditional use of life insurance as financial protection against premature death was being overshadowed by its use as a tax-favored investment. The Subcommittee's study culminated in the enactment of section 7702, the Federal tax definition of a life insurance contract. This Subcommittee is now asking, in effect, whether single premium life insurance policies are overly "investment oriented." A review of section 7702 will, we believe, assist the Subcommittee in its current search for the answer to that question.

A. Section 7702

Section 7702 contains two alternative tests by means of which a contract can qualify as a life insurance contract for Federal tax purposes: (1) a cash value accumulation test, and (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. The cash value accumulation test was designed to allow traditional whole life insurance contracts "with cash values that accumulate at reasonable interest rates" to qualify as life insurance contracts. Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, p. 647 (1984) (the "General Explanation"). The guideline premium requirement of the second test "distinguishes between contracts where the policyholder makes traditional levels of investment through premiums and those which involve greater investments by the policyholder," while the cash value corridor requirement "disqualifies contracts which allow excessive amounts of cash value to build up . . . relative to the life insurance risk." General Explanation, pp. 649-50. The cash value corridor requirement thus assures that if a life insurance contract develops a higher cash value than the life insurance company guaranteed at the time the contract was issued (because of higher interest being credited to the policy's cash value, for example), the policy's death benefit will increase. The General Explanation concludes that together "these requirements are intended to limit the definition of life insurance to contracts which require only relatively modest investment and permit relatively modest investment returns." Id.

In developing these definitional tests, this Subcommittee specifically reviewed the investment orientation of a number of life insurance products. Some products which traditionally had been sold by life insurance companies, such as endowment contracts, were determined to be too investment oriented; these products were excluded from the tax definition of a life insurance contract. Single premium life insurance contracts were carefully considered in this review.

During the Subcommittee's review of life insurance products, it recognized that a permanent life insurance policy's cash value is a byproduct of the advance payment of the cost of insurance. As a consequence, a life insurance policy which is purchased with a single premium will have a higher cash value than one which is purchased with premiums payable for the whole of life. That is not to say, however, that such a policy is too "investment oriented." To the contrary, after extensive consideration, this Subcommittee determined that the fact that a life insurance policy is purchased with a single premium does not in and of itself mean that the policy is too investment oriented. Thus, this Subcommittee, and ultimately the Congress, specifically concluded that single premium life insurance policies should continue to be treated as life insurance contracts for Federal tax purposes.

This Subcommittee also concluded that, although section 7702 should allow single premium life insurance policies to qualify as life insurance contracts, that section should impose strong constraints against the use of such policies principally as investments rather than to provide life insurance protection. One example of this is that the guideline premium test imposes a stricter assumption with respect to the interest rate used to calculate the guideline single premium (6 percent) than it does for the calculation of the guideline level premium (4 percent). The effect of this stricter interest assumption is to reduce the amount of the premium which could otherwise be paid for a given amount of death benefit. Another example is that, in making the single premium determinations under either of the two definitional tests, it must be assumed that the policy's death benefit does not increase; in contrast, certain increasing benefit patterns may be reflected in determining level premiums. This rule was specifically intended to limit the investment orientation of a single premium life insurance policy, and its effect also is to reduce the amount of the allowable single premium payment.

Despite the constraints imposed by section 7702, some have proposed to amend the Code's definition to preclude single premium life insurance policies from being treated as life insurance for tax purposes. One such proposal is that of the National Association of Life Underwriters. That group proposes that the definition be modified by grafting onto it a new 5-pay test. This test would introduce into section 7702 new statutory restrictions on the mortality costs and the expense loads that could be used in calculating the test premiums.

The Committee of Life Insurers believes that adoption of any such proposal would be a serious mistake. When this Subcommittee was developing the section 7702 definition of life insurance, it rejected a proposal to require life insurance policies to be purchased with a minimum of 10 premiums. The failings of that 10-pay proposal, as well as additional failings, are embodied in the NALU 5-pay proposal. If the NALU proposal were adopted, a life insurance policy which qualified as life insurance when purchased would lose its qualified status if an individual allowed the policy to lapse, pursuant to state law, into paid-up coverage with a reduced death benefit. (Such a lapse occurs when an individual can no longer afford to make his or her premium payments.) In addition, if the NALU proposal were adopted, it would be difficult, if not impossible, for a policyholder to exchange a life insurance policy for which more than five annual premiums had been paid for a new policy, whether with the same or a different company. Locking policyholders into a policy is not only unfair to the policyholder, but also anticompetitive.

The NALU proposal also regulates on a de facto basis the charges a life insurance company can impose for the mortality risks it assumes under a life insurance contract, as well as the expenses which it can reflect in the premiums charged. Adoption of such price regulation would be unprecedented and unwarranted. The Internal Revenue Code should not regulate the price of life insurance policies.

Currently, the investment aspect of life insurance policies stretches across a spectrum with single premium policies being the most investment oriented and term life insurance being the least investment oriented. If the definition of life insurance were amended, as NALU proposes, to require that a minimum of 5 premium payments be used to purchase life insurance coverage, such a policy would still be more investment oriented than a policy which was purchased with 20 premium payments. A 20-pay policy would in turn be more investment oriented than a whole life policy, and a whole life policy would be more investment oriented than term life insurance.

Consequently, as long as permanent life insurance has a savings element which is not subject to current taxation, some person will undoubtedly tout that product as a "tax-shelter." Simply because this characterization has been applied to single premium life insurance policies, this Subcommittee should not conclude that such policies are abusive and their sale should be ended, as would happen if the NALU proposal were adopted. Accordingly, we urge this Subcommittee to reject not only the NALU proposal, but any similar proposals which would result in single premium life insurance policies not qualifying as life insurance contracts for Federal tax purposes.

B. Surrenders and loans

The Tax Reform Act of 1986 amended section 7702 to limit further the possible use of life insurance contracts in general, and single premium life insurance contracts in particular, as investments. Traditionally, amounts received under a life insurance contract as a result of partial withdrawals or surrenders of the contract have been taxed only after the policyowner has recovered his investment in the contract. That is, such amounts constitute first a withdrawal of the policyowner's investment in the contract, and then a withdrawal of any gain in the contract.

As part of the 1986 tax reform process, Congress reviewed the distribution rules for life insurance contracts. Some members of Congress and representatives of the Treasury believed that application of the traditional rule was inappropriate in circumstances where a life insurance contract had a cash value that was the maximum, or close to the maximum, allowed by section 7702. As a result, section 7702(f)(7)(B) was amended to provide that if, during the first fifteen years after a life insurance contract is issued, there is a reduction in the death benefit and amounts are withdrawn from the policy, then in specified circumstances "a portion of the cash distributed to the policyholder . . . will be treated as being paid first out of income in the contract, rather than as a return of the policyholder's investment in the contract . . . ." Joint Committee on Taxation, Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation, p. 107 (1987).

This rule affects single premium life insurance policies in particular and generally prevents a policyowner from making a substantial partial withdrawal of cash values free of tax during the first 15 years after the policy is purchased. For example, consider an individual aged 45 who purchases a single premium life insurance contract with a death benefit of $75,000 and pays a premium of $18,480, which is the maximum premium section 7702 allows for that particular contract. If two years later, when the policy's cash value is $21,356, the individual partially surrenders his contract and reduces the death benefit to $65,000, while receiving $2,680 of the policy's cash surrender value, all of that amount will be included in the individual's income under the 1986 amendment to section 7702.

The ability of a policyowner to withdraw the cash value of his single premium life insurance policy is constrained not only by the 1986 amendment of section 7702, but also by the design features of such policies. Single premium life insurance policies (like other non-term life insurance policies) are intended by insurers to be permanent life insurance contracts. In order for the insurer to make a profit on such contracts, the contracts must remain in force and the cash value of the contacts must remain with the insurer for a substantial period of time. Thus, many single premium life insurance contracts impose a substantial surrender charge if the policyowner surrenders the contract within seven years of purchase, while many others impose such charges if the surrender occurs within ten years.

Policyowners do, of course, have a state law mandated right to borrow some or all of the cash value of a life insurance contract. Nevertheless, like most other permanent life insurance contracts, single premium life insurance policies contain certain disincentives to borrowing. For example, interest paid on policy loans under single premium life insurance policies has not been deductible for many decades. Most importantly, if a policyholder does not repay a loan, the death benefit proceeds payable to the insured's beneficiary will be reduced by the outstanding amount of the loan and any unpaid interest on the loan.

We recognize that a number of advertisements for single premium life insurance policies have highlighted the right of a policyowner to borrow against the policy's cash value. Again, however, a significant gap exists between what has been emphasized in some advertisements and what policyholders actually do. Based on the survey we conducted, very few policyholders borrow from their single premium life insurance policies -- only 8.4 percent of single premium life insurance policies have a policy loan. Furthermore, this experience is consistent with policyholders' intentions with respect to future borrowing. In a recent survey, 75 percent of the single premium policyholders of one company stated that they did not expect to borrow from their policy. In addition, those policyholders who have borrowed are not borrowing large sums -- only 3.7 percent of the cash values of single premium policies have been borrowed.

In view of these facts, we believe that the changes in the long-standing treatment of distributions from life insurance policies and of life insurance policy loans that are proposed by HR 3441 are unwarranted.

V. Conclusion

We ask that this Subcommittee judge single premium life insurance policies on the basis of the facts and not on the basis of imagery created by advertisements. As explained previously in this statement, single premium life insurance policies provide the same valuable social function as other forms of permanent life insurance -- they offer substantial death benefits combined with long term savings. Adoption of a proposal such as that advanced by NALU would mean that individuals would no longer be able to purchase life insurance coverage with a single premium. This would require individuals to purchase life insurance on an installment basis, increase the cost of life insurance coverage for some individuals, and it could well mean that some older persons who would otherwise provide for their own care and that of their spouses by purchasing life insurance will not do so. In addition, we respectfully submit that the available data with respect to policy loans shows that no changes in the longstanding rules with respect to distributions from life insurance contracts are necessary.

If this Subcommittee nevertheless concludes that some change in the current Federal income tax treatment of life insurance is warranted, we will be pleased to cooperate with the Subcommittee members and their staff. Hopefully, out of such a joint effort we will reach a result that will alleviate the Subcommittee's concerns without discouraging the purchase of any type of life insurance contract.

Respectfully submitted,

Robert G. Sharp
Harry L. Edwards
Donald C. Alexander
Will D. Davis

On behalf of the Committee of
Life Insurers

March 15, 1988

Committee of Life Insurers

Charter National Life Insurance Company	St. Louis, Missouri
Connecticut National Life Insurance Company	Simsbury, Connecticut
Executive Life Insurance Company	Los Angeles, California
Family Life Insurance Company	Seattle, Washington
Fidelity Bankers Life Insurance Company	Richmond, Virginia
First Colony Life Insurance Company	Lynchburg, Virginia
Guardian Insurance and Annuity Company, Inc.	New York, New York
IDS Life Insurance Company	Minneapolis, Minnesota
Integrated Resources Life Companies	Fort Lee, New Jersey
Jackson National Life Insurance Company	Lansing, Michigan
Kemper Investors Life Insurance Company	Chicago, Illinois
Keystone Provident Life Insurance Company	Boston, Massachusetts
Midland Mutual Life Insurance Company	Columbus, Ohio
National Home Life Assurance Company	Valley Forge, Pennsylvania
National Western Life Insurance Company	Austin, Texas
Nationwide Life Insurance Company	Columbus, Ohio
North American Company for Life and Health Insurance	Chicago, Illinois
North American Security Life Insurance Co.	Boston, Massachusetts
Provident Mutual Life Insurance Company of Philadelphia	Philadelphia, Pennsylvania
Sun Life Assurance Company of Canada	Wellesley Hills, Massachusetts
United Pacific Life Insurance Company	Federal Way, Washington
Xerox Financial Services Life Insurance Co.	Lisle, Illinois

Mr. **Flippo**. Thank you, Mr. Edwards.

Mr. Alexander.

Mr. **Alexander**. In view of the hour, I will add nothing to what my friends said.

Mr. **Flippo**. We will include all your statements in the record in their entirety.

Mr. Oakes.

STATEMENT OF GORDON N. OAKES, JR., CHAIRMAN OF THE BOARD AND PRESIDENT, MONARCH CAPITAL CORP., SPRINGFIELD, MA

Mr. **Oakes**. I represent Monarch Capital Corp. of Springfield, Mass., which is the largest seller of single-premium insurance in the country. We are also the largest seller of variable life insurance in the country.

I would like to take a few minutes to tell this committee how we got to the position we are in.

In 1979, the FTC issued a report highly critical of the life insurance industry. Among other things, it said that the consumers of this country were losing billions of dollars a year on the savings portion of their life insurance policies, and the life insurance industry should respond to that criticism.

The life insurance industry did respond to that criticism. I can certainly say Monarch responded to that criticism in that same year 1979, creating a new product called variable life, and creating a new source of distribution.

You should be aware we have a significant stake in the outcome of these hearings, because we have a tremendous investment in the variable life product and the product line with new systems and new methods of reaching the marketplace. We think we have created a superior consumer product, and we began marketing that product in 1980.

We started with an annual pay product and learned from the marketplace there was a demand for a single-premium product. That demand first occurred in 1981, when we issued our first single-premium product.

That demand came from several sources, but one of those sources was from the individual who was in his midfifties, whose life insurance coverage had not kept pace with inflation, and needed to find a way to get a paid up policy because there were not many income producing years left. There were several other sources in the marketplace that demanded a single-premium product.

During the years 1981 to 1986, we broadened our distribution. We refined our product.

We complied with the changing definitions of tax law and we found that our growth was fairly substantial during that period of time, largely in single-premium product.

In 1986, there was a change in the tax law. It didn't affect the single premium product, but it did eliminate tax shelters. It has been referred to several times this morning.

One of the things that happened is that we saw a number of life insurance agents and companies advertise single-premium life insurance as the last great tax shelter.

Mr. McGrath has been asking all morning what is this great tax shelter? He has been trying to find one.

I think the answer is that it isn't as great as it has been advertised and I think the advertisements have been misleading and have not properly represented the product.

I will speak for our own product to give you an example.

A 55-year old, who had $25,000 to put into a single-premium life insurance, our prime plan, and did so would find at age 65, assuming a 7¾ percent return, would have a cash value of $41,500. That same individual at that same age investing in a taxable savings instrument, the cash value at the end of the 10-year period would be $43,000.

You have to understand the $43,000 is all available; the $41,500 in the life policy is not all available. And had that same individual invested in a tax-free vehicle at that same interest rate, the value at the end of that 10-year period would be $52,700.

I think the misrepresentation of it being a great investment vehicle are just that, misrepresentations.

We talked about the problem and Congressman Stark started the proceedings this morning asking what the problem is and trying to define the problem. I am not sure that we know exactly what the problem is, but we have heard solutions to the problem.

One of them is the solution which would eliminate the single pay product, and leave in its stead a multipay and a multicommission product; this would put the policyholder in jeopardy in terms of continuing coverage.

You should be aware that one third of the policies that are paid for on an annual payment—on an annual premium basis at the end of 5 years have lapsed. If you have a single pay product, it is permanent life insurance, fully paid for and will remain in force, which I think accomplishes one of the goals that we are trying to accomplish in this committee.

Our problem—our loan problem; well, we heard a lot of statistics this morning. I would just offer our own statistics, reminding you we have been in the business since 1981.

Eighty-eight percent of our policyholders have never borrowed. Ten percent of our policyholders currently have loans outstanding. The median value of those loans is $6,000. If you aggregated those loans, they would represent 7 percent of the total cash value of the life insurance that we have in force.

So we don't think loans are a problem. However, if you focus on this problem, and you look at the goals that you have as a committee, you look at the tax policy goals that have been so well articulated this morning. We are concerned about the savings rate this country. If you are, in fact, concerned about increasing the amount of insurance in force as the socially acceptable goals life insurance represents, then there are alternatives to the legislation and modifications to the legislation that Congressman Stark suggested.

I will offer three. One, we could cap loans at $50,000, the same as is done in 401(k) plans and require payment in 5 years. That is existing regulation that could be adapted for life insurance.

Second, we could allow hardship loans for the elderly, for long-term care, for medical expenses, for educational expenses, all of which I think this committee would agree are certainly worthwhile goals.

Third, if you are concerned about the wash loan nature—and incidentally we do not offer wash loans on our product—and I would remind you again we are the largest seller of single-premium product—you could require a 2 percent interest spread and also take the additional step of only allowing tax-free loans after a 5-year period of time.

In any event, the loan should be taxed only on a pro rata or LIFO basis. There should be a tax credit for repayment. Incidentally, 75 percent of our policyholders who borrow anticipate they will repay their loans. And there should be no penalty imposed beyond the tax treatment of loans.

Finally, any change that is agreed to should apply only to new policies. Monarch wants to be part of the solution.

We want to work with the committee. We have a big stake. We have been a force in the insurance industry to continue the sale of single premium products. We think it is important for this country.

Thank you very much.

[The statement of Mr. Oakes follows:]

MONARCH CAPITAL CORPORATION

GORDON N. OAKES, JR.
CHAIRMAN OF THE BOARD AND PRESIDENT
BEFORE HOUSE WAYS AND MEANS COMMITTEE
SELECT REVENUE SUBCOMMITTEE
MARCH 15, 1988

As the leading writer of single premium variable life insurance in the country, Monarch Capital has a tremendous stake in the outcome of any changes in the tax treatment or definition of life insurance. Monarch began selling single premium life insurance in 1981. We are willing to take the steps necessary to correct any current abuses of life insurance's tax status. Monarch wants to be part of the solution, not the problem.

WHAT HAPPENS IF I LIVE TOO LONG OR DIE TOO SOON?

Our company is just one of many that has been and will continue to be responsive to criticisms of the industry - not with words but with actions. In 1979, a Federal Trade Commission (FTC) study stated, "With 55 cents of each premium dollar going to what are essentially savings accounts, buyers...of whole-life insurance are losing billions of dollars a year." The report went on to discuss the inadequacy of the information the consumer gets on the cost of these policies, the dismal rate of return they earn, and the undisclosed penalties of surrendering a policy.

The insurance industry responded to these criticisms with a new generation of interest and market sensitive products, including universal life and variable life. With these products, the consumer was able to get market rate returns on their cash values and whole life insurance could efficiently do what it was designed to do - solve the economic problem, "What happens if I live too long or die too soon?" This is the question every consumer faces, because one or the other event will happen. That is why whole life insurance was created.

In addition to changes in the return on the policies, annual reports allowed consumers to see exactly how their cash value was growing and what charges were deducted from this cash value each year. At point of sale, ledger illustrations clearly showed assumed rates of return and allowed comparisons between companies. The consumer also had the right to choose how and when this coverage was paid for based on his or her financial situation - quarterly, yearly, or even in one lump sum payment. With inflation in the 1970's significantly eroding the buying power of insurance benefits, the lump sum payment method became very important. A 55 year old man could boost his lifetime insurance coverage by $50,000 with a single payment of $27,000.

1986 TAX REFORM ACT

In 1986, life insurance took on a new twist, at least in the press and in the eyes of some companies. With the elimination of many tax deductions, life insurance, with its loan provisions, was touted as an excellent way to defer or eliminate taxes on investments. This claim was especially promoted with single premium whole life policies - particularly versions that allow the policyowner to take out loans at a 0% net cost while not even deducting from the cash value each year the cost of the insurance coverage. Was life insurance even being sold as life insurance any more?

WHY DO PEOPLE BUY LIFE INSURANCE?

One whole life insurance brochure used by our agents in 1975, entitled the "Four in One Plan", does not mention insurance on either cover. The back cover lists ~~its~~ benefits as, "retirement income, immediate estate, emergencies & opportunities and self-completing if totally disabled." Life insurance is only mentioned two places in the brochure, and odds are, if it could legally have been eliminated from the discussion, it would have been. The words "death benefit" appear nowhere. Advertising life insurance as a savings plan is nothing new.

Our recent discussions with sellers illustrate that good old fashioned reasons to buy life insurance are still the same today as they have been in the past. For our Prime Plan single premium variable life holder, who is, on the average, age 56 when he buys this plan, retirement, long-term health care and estate planning are still primary goals. (A recent poll conducted by the American Association of Retired Persons (AARP)/Villers Foundation indicated that 86% of the public believes some government action should be taken to provide for long-term care of Americans.) Policyholders like the tax free growth in their insurance policies. But certainly just as vital to the sale is the death benefit that remains in effect for the insured's entire lifetime and is more than the conservative investor could ever achieve without the aid of life insurance.

Why is this important? For the farmer who is land rich and cash poor, life insurance could be the only substantial cash asset his spouse receives on his death. For the unmarried retired schoolteacher, single premium life insurance is collateral against the expenses of nursing home care that may loom ahead of her. These are actual cases related to us by agents.

Even for younger policyholders, fear, rather than greed, is a big motivator. Young parents facing astronomical college costs use single premium plans as a first step in planning for those expenses....and the insurance element guarantees the plan will be self completing. If the breadwinner dies, the money will be there when needed. For example, a $10,000 premium for a 35 year-old father buys an immediate death benefit of $166,773. If the father dies the day after buying this policy, there is money for the future education of his child. If money is needed for an emergency, it is available for borrowing. What other vehicle can offer this guarantee?

Small business owners are other frequent purchasers of our single premium policy. These owners are required to have insurance as collateral against business loans. The investment base of a single premium life policy can serve as the "emergency fund" for those unforeseen financial crises that a small business can face.

LOAN PROVISIONS

Much of the concern in Congress with single premium policies has been with the loan provisions. Are policyowners taking out all the growth through the loan provision? Monarch's experience indicates no. In our single premium variable life business, 88% of policyholders have never taken out a loan. Current debt outstanding on policies is just 7% of cash values. Ten percent of policies have a loan outstanding. The median size of a loan is $6,000.

In anticipation of this hearing, we polled customers calling in to request a loan. Frequently stated reasons for loan requests were to help a family member in need, financial emergencies, medical expenses, and educational loans. There were, however, some discretionary purchases with loan money, and one-third of our loan takers indicated they had no intention of paying the loan back.

A survey of our agents also showed that single premium loans are primarily used for long-term care and emergency financial needs. We know of a hog farmer whose hogs became diseased. He used the loan provision to borrow the money he needed to pay his bank loan and save his farm. We have a grandmother who purchased a small Prime Plan after her granddaughter was born without an eye. The child will have to undergo extensive surgical procedures over many years. The cash value in this policy will be used to pay a portion of the costs associated with this child's medical treatment.

WHY ARE STOCK BROKERS SELLING INSURANCE?

Along with traditional career agents, Monarch's variable product line can be bought through stock brokers who have been trained and licensed to sell life insurance. This distribution system was the chief reason Monarch was initially able to offer variable life insurance. The expenses associated with the development of a variable product, including outlays for product design and registration, computer systems and a whole new type of customer service department, are considerable. Monarch could never have offered this product to the consumer without the added distribution capabilities of brokers and financial planners. Our product and distribution systems helped revolutionize the way insurance is designed, marketed and sold.

Monarch's expanded distribution methods created resentment in the industry from traditional insurance sellers. With the introduction of our single premium variable life policy, there was a substantial alteration in the amount and frequency of commission payments. With a one-time agent commission of 3.5%, agents accustomed to a 50 to 90% first year commission and 5 to 10% commissions in subsequent years were threatened. For example, a $10,000 Prime Plan for a 35 year old male with a face amount of $166,773 generates a one-time commission of $350. In contrast, our highest commission paying annual premium variable policy with a yearly premium of $1,000 and a face amount of $116,379 for the same individual produces $500 in commissions the first year and $200 more over the next four years. The lower commissions in our single premium insurance product translate into higher consumer value.

For some agents, there is hard dollar motivation to get rid of this low commission product. And with a slowdown in the growth of the insurance industry, these individuals are jealously guarding their territory against the invasion of brokers, banks, or whoever else attempts to meet the security needs of the American public.

TAX ADVANTAGES ALONE DON'T JUSTIFY BUYING LIFE INSURANCE

Our single premium variable life product does not make economic sense to the consumer unless there is a need for life insurance. If you want a "pure investment" you would not buy our major single premium policy, Prime Plan. Assuming a 7.75% return over 10 years and a 28% tax bracket, the 50 year old Prime Plan owner who invested $25,000 has $41,500, of which only $37,350 is available through a policy loan. However, $280 a year in interest must be paid or the policy will eventually lapse and the entire growth will become taxable. A similar investment of $25,000 would generate an after tax growth to $43,029. By putting the same $25,000 in a tax free municipal bond, earning 7.75%, the individual ends up with $52,737 as compared to the loan value of $37,350. In addition, any losses under a Prime Plan are not tax deductible. Where there is an insurance need, the Prime Plan holder with his $25,000 purchases an initial death benefit of $52,759 that grows, assuming the 7.75% return, to a death benefit of $72,304 by the end of 10 years.

CHANGES IN THE TAX TREATMENT OF LIFE INSURANCE

That there needs to be changes in the life insurance industry is a given. At the same time, we must be careful not to make changes that take the industry back to 1979 when insurance was eating away at the financial growth of families rather than adding to this growth.

The NALU proposal in particular comes to mind. This proposal requires a multiple pay policy, with multiple years of commission payments and multiple opportunities for policy lapses and replacements. LIMRA statistics show that one-third of all insurance policies lapse by the end of the fifth year. This means that the NALU proposal would benefit the agents and certain companies at the expense of the consumer. In addition, the NALU proposal regulates the rights of policyholders to decide how they wish to pay for their insurance coverage and places restrictive controls over interest, mortality and expense assumptions used to calculate allowable premiums. This proposal would also lower the investment value per dollar spent by the consumer. The result will be a policy that answers the question, "What if I die too soon?" but may leave the consumer who "lives too long" woefully underprepared.

If the NALU proposal becomes law, the concept "buy term and invest the rest" may then be the best alternative. But for those individuals whose health or age precludes the purchase of term insurance and for those who understand that the need for insurance doesn't disappear as you age and term costs become prohibitive, the alternative becomes a whole life policy with limited returns, limited disclosure requirements and very limited long term value to the consumer.

RECOMMENDATIONS

From a federal tax policy standpoint, Monarch understands the concerns about life insurance policy loan abuses. We believe that the potential abuses cannot be seen as purely single premium policy issues. We believe some of the concepts put forth by Members of the Committee to deal with the potential for abuse deserve further consideration and refinement.

We'd like to suggest some options that the Committee may want to consider when they approach changing the tax status of life insurance.

1. Cap tax-free loans at $50,000 and require the repayment of the loans by the end of five years as is currently required for 401K plan loans.

OR

2. Allow policy loans without taxes for hardship cases, including exemptions for the elderly, long-term care and college education costs.

OR

3. On a technical side, require a 2% spread between loan and credited rate, and restrict tax free borrowing for the first five policy years.

In all cases, any tax should be applied on a pro-rata or FIFO basis and a tax credit should be allowed for the repayment of loans that are taxable. In light of the dual purpose of cash value life insurance, the 10% penalty tax should not be imposed. And as a simple matter of fairness, any legislative changes should only apply to new insurance contracts.

As we stated in the beginning, Monarch wants to be part of the solution, not part of the problem. We hope to be able to cooperate with the Committee in addressing legitimate concerns about abusive loan practices.

Mr. **Flippo.** Mr. Clark.

STATEMENT OF WILLIAM J. CLARK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, MASSACHUSETTS MUTUAL LIFE INSURANCE CO., SPRINGFIELD, MA

Mr. **Clark.** I appreciate the committee's invitation to testify regarding single-premium life insurance. Although I represent only my own company, my recommended solution to the single-premium problem is not only supported by the National Association of Life Underwriters, but also by a number of other companies, some of whom will present written testimony.

In 1986, when the insurance industry lobbied the Congress to protect the tax treatment of life insurance during tax reform, we very earnestly and correctly described life insurance as life insurance protection, making clear it was not an investment and therefore should not be taxed as an investment product. We explained that the cash value of our product was needed to prevent premiums from increasing as the insured grew older. Permanent life insurance both whole life and universal life we explained, was indeed protection for life.

To our relief, Congress agreed and life insurance essentially retained the same tax treatment that it has had over many, many decades. However, the chagrin of those of us in the industry, shortly after tax reform became law, full page ads were purchased by some companies advertising single-premium insurance as the last great tax shelter.

Single-premium insurance was decribed as a tax-free, divested mutual fund with no tax payments on dividends or capital gains and with a right of withdrawal without tax, in the form of loans.

The single-premium product now being sold is, in fact, a great tax shelter. I don't believe this loophole, which has been advertised widely not only by various segments of the life insurance industry, but also by the business and financial press, was intended by Congress. If the single preminum abuse continues, I believe we in the insurance industry lose credibility. Frankly, I am, very concerned that the enormous new single-premium sales and the resulting wide publicity from these sales will tempt you in Congress to penalize all life insurance products rather than zeroing in on the single-premium abuse as is necessary. If that occurs, you would in effect, be throwing out the baby with the bath water.

It is for that reason that I and a number of other companies support the National Association of Life Insurance Underwriters' solution, sometimes described as the definition of life insurance approach. That approach would simply amend the present definition of life insurance by increasing the required amount of pure insurance protection in a range from 50 to 100 percent. As a result, the investment element in what would then qualify as life insurance could no longer be marketed successfully as an investment product.

We support the NALU proposal because it is the simplest, most direct, and most effective means of closing the single-premium loophole. The approach zeros in on the specific abuse, while it does not adversely affect either traditional whole life or universal life, both of which have served the needs of the Nation for many years.

I will not describe the approach further—it has already been described in some detail by NALU. Instead, I would like to comment on H.R. 3441.

I respect the sponsors of this bill, but am concerned by their attempt to penalize all life insurance rather than directly addressing the single-premium problem. The fact is that H.R. 3441 will not close the single-premium loophole. It will only narrow the loophole, while it will definitely harm all annual premium life insurance. In short, it punishes the innocent rather than the real culprit.

I have heard some say that the definitional solution is not practical and that it will not work. I grant nothing is perfect; but on a scale of 10, the definitional approach would surely reduce the problem from its present level of 10 to perhaps a 1 or a 2 on the scale, which is far more than can be said about the directional approach.

In closing, I would like to emphasize one thing. I am not here because I am philosophically opposed to the sale of single-premium life insurance, even under the current rules. If you, this committee, find those rules acceptable, my company, for one, will continue to sell this product and will let the good times role. However, if you decide to close this loophole, please do just that; close the loophole.

Do not penalize either traditional whole life or universal life. They have not been the problem.

I appreciate the opportunity to express my views. I would be more than happy to answer questions.

[The statement of Mr. Clark follows:]

STATEMENT OF WILLIAM J. CLARK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY

Mr. Chairman and members of the Subcommittee, my name is William J. Clark and I am the Chairman and Chief Executive Officer of Massachusetts Mutual Life Insurance Company. I appreciate the Subcommittee's invitation to testify today concerning "single premium" life insurance, so-called "insurance" policies that you buy with one lump sum, instead of with payments over a period of time.

For almost a year now, Congress has been aware of the problems surrounding single premium policies. Today these policies are essentially investment products, which exist solely to exploit a loophole in the Internal Revenue Code. This loophole enables these investment instruments to escape taxation by masquerading as life insurance. As a result, single premium life raises legitimate concerns about (1) the working of the Tax Code's definition of life insurance, and (2) the marketing of insurance as an alternative form of financial investment. We share the Subcommittee's concern about these matters and, for reasons described below, believe that the problems posed by single premium "insurance" are so serious that the definition of life insurance should be changed so that it will no longer be possible to sell this product with the tax benefits for life insurance.

Some of you may recall that I came to Washington last year and spoke with members of this Subcommittee about single premium life insurance. At that time, I told you that my purpose in coming was to find a solution that would promptly end the tax shelter sale of single premium policies, without harming legitimate permanent life insurance. Today that is still my purpose, but my concern has been heightened. My heightened concern is with H.R. 3441, or "Stark/Gradison," the bill introduced last year purportedly to deal with single premium life insurance. Not only will this proposal fail to end the sale of single premium policies as tax shelters, but it will severely harm the purchasers of true life insurance.

Before I proceed further, I believe that a short explanation of the nature of my company will help make my remarks more meaningful. Massachusetts Mutual is a traditional mutual life insurance company. We sell our life insurance through 104 general agencies located throughout the United States. We have been in the insurance business for over 136 years. We specialize in the sale of annual premium, whole life policies, but we sell all types of life insurance, including universal life, term insurance, some single premium policies, and a number of other products. Last year, 27 percent of our new business came from single premium life. We are, however, willing to give up this product in the interests of a solution to the single premium problem that will not penalize all permanent life insurance, including whole life.

Whole Life Insurance is Not the Problem

Today you are hearing much about H.R. 3441. This bill, however, is not about single premium life; it is about permanent cash value life insurance. H.R. 3441 does nothing to address the investment orientation of single premium insurance -- the principal problem with, and attraction of, this product. Instead, H.R. 3441 proposes to revise the tax treatment of policy loans and distributions not only for single premium policies, but for all permanent forms of life insurance as well. This distributional approach would not close the single premium loophole, but it would have a grave impact on "whole life" insurance, a type of permanent insurance that contains "cash values."

Whole life is a valuable product that has been around for many years. Some critics of whole life imply that its cash value feature represents an abuse. This is simply not so. Whole life cash values make it possible to charge level policy premiums. This level premium design serves a very useful purpose: it spreads out the cost of insurance over the insured's life, allowing individuals to have lifetime protection at a fixed cost. Individuals who are over 50 will have reasonable insurance costs, at a time when the cost of term insurance, for example, can be prohibitive.

Mr. Chairman, and members of the Subcommittee, I own whole life insurance and many of you own whole life insurance. We bought it many years ago, we pay our premiums every year, and we do not think of it as an investment. If an emergency arises, like a family illness, we may borrow against it to help pay these unexpected health bills, or to pay the premiums on the policy to keep it in force. This is not an abuse, and whole life and universal life are not abusive products.

However, there is in the life insurance market an abusive product and that is single premium life. It is abusive because it is predominantly an investment vehicle, dressed in life insurance clothing. We are here today to determine how to close the loophole that allows this product to be sold with the tax benefits for life insurance. For reasons I will explain shortly, if H.R. 3441 (or similar distributional proposals) passed tomorrow, the single premium loophole would remain open.

The sponsors of H.R. 3441 and those companies that are asking you to look at ways to curtail policy loans (and distributions) are concerned with something other than single premium life. They are concerned with distributions from all insurance policies. Generally, the companies supporting distributional approaches currently sell -- and hope to continue to sell -- substantial amounts of single premium life. Apparently, their strategy is to give up policy loans in order to preserve the predominantly investment orientation of single premium policies. Why? Because the tax incentives for life insurance have made single premium life such a "hot" investment product that companies are willing to accept major revisions to the taxation of life insurance in order to continue selling the product. If this strategy succeeds, the losers will be the Federal Treasury and purchasers of true life insurance.

Description of the Single Premium Problem

According to the General Accounting Office ("GAO"), single premium sales grew an astonishing 318 percent between 1984 and 1986, from about $1.0 billion of premiums in 1984 to over $4.3 billion in 1986. (See U.S. General Accounting Office, Taxation of Single Premium Life Insurance, p. 19, 10/87.) Moreover, preliminary reports for 1987 put single premium sales at almost $10 billion. These are astonishing -- and troubling -- statistics.

Mr. Chairman and members of the Subcommittee there are two essential points to note about single premium products: they are investments and they exist solely to exploit a tax loophole, which enables these investments to masquerade as insurance. The true nature of single premium contracts is illustrated perhaps most vividly by the circumstances of their sale -- who sells them, to whom and why.

- In 1987 over half of all single premium policies were sold by stockbrokers, not life insurance agents. Indeed, the New York Times reports that stockbrokers go to special seminars to learn about this 'currently popular' product. (NYT, p. 14, 7/19/87)

- One insurance company has formed a joint venture with a mutual fund to market single premium contracts. (Business Week, p. 101, 9/21/87)

- The vast majority of single premium policies -- 68 percent -- are sold not to young families, but to older persons, and these older customers generally have very high incomes. (GAO Report at 23-25) Evidence suggests that they are diverting discretionary investment assets into single premium insurance in order to accumulate tax free investment gains.

- The GAO reports that single premium sales grew 318.2% from 1984 to 1986, at the same time that new CD sales fell by 80%. Sales of periodic premium policies grew during this time by only 13 percent. (GAO Report at 19)

- Immediately after the October market crash, when investors sought an alternative to equity investments, they turned to single premium life. One major single premium company reports that sales of single premium contracts "were higher the week after the [stock market] crash than they were the week before." (Business Week, p. 172, 12/28/87)

Clearly, single premium products are not insurance. They are investments in a thin insurance wrapper.

- Single premium policies are "cash rich" -- there is little insurance protection in the policy in relation to investment dollars (premiums and accumulated interest).

- There is so little insurance involved in single premium policies that most are sold without requiring the insured to take any sort of medical exam. This is unusual at the older ages typical of single premium customers.

- According to the GAO, in 1985 traditional ordinary life insurance policies -- when compared to single premium policies -- provided over 40 times more death benefit for the average premium. (See GAO Report at 21)

The investment-oriented nature of single premium policies stands in marked contrast to traditional life insurance policies. Traditional policies are not sold as investments, and are not perceived by consumers as investments. Rather, the primary purpose of these policies is to provide insurance protection. Unlike single premium policies, traditional insurance is (1) sold by life insurance agents, (2) contains a substantial element of insurance protection, and (3) generally requires medical examinations and medical underwriting.

Single premium products are taking advantage of a loophole that Congress never intended to create. Congress provides certain tax benefits for life insurance because Congress has long recognized that the purchase of life insurance promotes the public interest.

Mr. Chairman, and members of the Subcommittee, I am not here today because I am philosophically opposed to the sale of single premium life under the current tax rules -- if you continue to find those rules acceptable. But I am here to ask that, if you close the loophole which allows these investment products to be sold as insurance, you do just that -- close the loophole -- and you do not take action that will in any way harm current or future policyholders of legitimate life insurance.

The Solution Proposed by the NALU is Responsive to the Single Premium Problem

We strongly support the proposal of the National Association of Life Underwriters ("NALU") that would tighten the definition of life insurance to exclude products containing only a thin veneer of life insurance. Congress took the first steps in this direction in 1984 when it added a definition of life insurance to the Tax Code (Section 7702). The NALU's proposal is both consistent with this approach and responsive to the single premium problem outlined above. Most importantly, the NALU proposal -- more so than any other proposal -- will effectively stop the drain on the Treasury caused by the sale of single premium policies.

Before we explain the mechanics of this proposal, some background on the current definition of life insurance may be helpful. The Tax Code definition of "life insurance" was intended to limit the investment element in contracts that qualify for the tax-favored treatment of life insurance. Thus, Section 7702 states that a contract will not be treated as life insurance unless it passes one of two tests, both of which require that a contract provide a minimum amount of pure insurance over and above the cash value or investment in the contract. Under the "cash value accumulation test," the cash surrender value of a contract may never exceed the "net single premium" necessary to fund the contract's future benefits. Under the "guideline premium test," the total premiums paid into the contract cannot at any time exceed the greater of the "guideline single premium" or the sum of the "guideline level premiums" up to that point in time, and the pure insurance in the contract may not be less than a varying statutory percentage of the cash surrender value.

As the Subcommittee can see, the current definition of life insurance makes single premium contracts the limit of what will be treated as life insurance for tax purposes. This standard was the product of a compromise reached in the House Ways and Means Committee during the waning hours of debate on the Committee's proposed definition of life insurance. That compromise did not solve an industry-wide problem. Rather, it was obtained by a limited number of companies that wanted to exploit the definition of life insurance by selling single premium policies.

Events following the adoption of this single premium standard make it clear that its significance was not fully understood by Congress when the standard was adopted. Changes in the tax treatment of investments in the 1984 and 1986 Acts made single premium products attractive to investors who seek tax advantages and who do not care about insurance protection. As a result, large amounts of single premium policies are being sold as pure investments.

Clearly, Congress never envisioned that single premium polices would become a large segment of the insurance market. A response is needed that will tighten the Tax Code's definition of life insurance so that these investment heavy contracts will no longer qualify for the tax benefits of life insurance. If companies want to continue to sell such contracts they should do so under the rules applicable to investment-oriented contracts -- the annuity rules.

A response is needed, however, that will end the quick, over-the-counter investment sale of single premium products as life insurance. The NALU's proposal is such a response. The NALU would simply add a threshold requirement to the current

Section 7702 definition of life insurance. That threshold requirement is that the amount of premiums paid in to a contract during the first five years cannot exceed the amount that the policyholder would have paid at that time if the policy provided for just five level annual premiums. This "five-pay" rule would substantially increase the required amount of pure insurance protection at the outset of a contract -- by about 50 to 100 percent.

The NALU's solution is responsive to the problem of single premium policies for several reasons. First it would add enough required insurance risk to increase the costs of insurance in early years. This increased cost would curtail the investment performance of single premium policies so that they will no longer attract discretionary investment dollars. Second, the amount of insurance involved would require companies to "underwrite" these policies. This should transform single premium products into a highly unusual and unattractive investment since potential customers may be required to submit to a medical exam -- with all its attendant procedures. Third, the customer would be required to make multiple premium payments to keep the policy in force. This should destroy any quick, easy "investment" sale of single premium products.

In short, consumers purchasing policies which must meet the definition of insurance proposed by the NALU will be purchasing life insurance, and the tax benefits accorded life insurance by Congress will not be used inappropriately for investment instruments.

There is at least one more advantage to the NALU's proposal. Not only does it respond to tax policy concerns, but it also responds to the charge that sales of single premium life have caused a drain on the Federal Treasury. The loss to the Treasury can be measured generally by the amount of tax that would have been paid on earnings from the huge amount of investment dollars placed in single premium insurance. The NALU approach will eliminate the use of single premium contracts as a depository for investment funds, and thus will stop this loss of tax revenue. H.R. 3441 -- the Stark/Gradison bill -- will not.

H.R. 3441 Will Not Solve the Problem of Single Premium Life Insurance

H.R. 3441 is the wrong approach to the problem of single premium life insurance for two reasons. First, it will not close the single premium loophole. Second, it will impose substantial adverse tax consequences on traditional life insurance -- insurance that many of us own and that we occasionally borrow against for family emergencies.

In general, H.R. 3441 and similar proposals would revise the tax treatment of policy loans and distributions not only for single premium policies, but also for annual premium policies: all permanent life insurance policies would be affected. Specifically, with respect to new premiums, H.R. 3441 would:

(1) change the basis recovery rules long applied to distributions from life insurance contracts to treat distributions from all life insurance policies first as a return of earnings and then as a recovery of the amount paid in as a premium;

(2) end the treatment of policy loans as loans, and substitute a rule which treats these loans as taxable distributions from the insurance policy to the extent of any earnings in the policy; and

(3) impose a 10 percent penalty tax on distributions from life insurance policies prior to age 59 1/2 -- in addition to the normal tax on the amount distributed.

This approach would do little to stop the tax shelter sale of single premium policies because it would not eliminate the investment oriented nature of these contracts. At the same time, it would curtail the ability of all policyholders to borrow against their insurance policies for such traditional purposes as medical emergencies, or their children's education.

H.R. 3441 is a meat ax when a scalpel is needed. Single premium policies present a specific problem, which calls for a specific solution: tighten the definition of life insurance to get rid of the products which are causing the problem. H.R. 3441, which is aimed at borrowing and distributions from all policies, is not appropriate because policy loans and distributions are not the problem.

Mr. Chairman and members of the Subcommittee, I would at this point like to clear up some apparent misconceptions concerning policy loans. Policy loans are not abusive features under traditional, annual premium policies. Policyholders who borrow from their insurance company, using their policies as security, generally do so because the loan proceeds are needed for reasons such as a sudden illness, a child's education, or to pay premiums to keep the policy in force. These are the sound, customary uses of policyholder loans on ordinary whole life policies.

Moreover, since the 1986 Tax Act made consumer interest generally nondeductible, policyholders must pay the interest on their loans with after tax dollars. As a result, policy loans no longer save tax dollars: the interest paid on these loans is not deductible. Furthermore, on surrender of the contract, the policyholder will pay tax on all the policy's earnings over the years -- an amount likely to be greater than the amount borrowed during the life of the contract -- and the tax bill may be greater than the amount received upon surrender.

This last point is not well understood. An example will help.

> Assume that at age 55 a policyholder pays a single premium of $100,000 to get a policy with a death benefit of approximately $303,000. For the next 15 years, the policyholder borrows $8,000 a year against the policy. These amounts are not taxed when borrowed, but the policyholder must pay nondeductible interest on the loan at a rate of 8.25 percent. The policy credits 8 percent interest to the cash value. At age 70, the policyholder has borrowed $120,000, and the policy is then surrendered to obtain the cash remaining of approximately $22,100. Upon surrender, tax must be paid on all the policy's earnings over the years of approximately $144,000. This taxable income is significantly greater than the $120,000 borrowed during the life of the contract. Moreover, at a 28 percent tax rate, the tax bill will be approximately $40,200, more than the $22,100 received on surrender. Finally, the policyholder's "real" gain from the contract is just $42,000 -- the loan proceeds, plus the cash surrender value, less the single premium. After taxes of $40,200, this amounts to a return of less than $2,000.

(A chart of this example is provided at the end of my statement.)

These same principles apply to loans on all policies and are the reason many policyholders (after the 1986 tax changes) are now repaying their policy loans. They may also be the reason why Tax Notes reports that those who have purchased single premium policies are not borrowing against these policies. (See Tax Notes, p. 763, 2/22/88.) In other words, even if purchasers can get a "wash loan" from their policy -- a loan at eight percent when the policy credits eight percent as well -- this feature is not the main attraction of single premium policies.

As to the provision in H.R. 3441 which would change the rules for taxing policy distributions generally, I would like to point out that Congress has already acted to discourage policyholders from withdrawing funds from their life insurance contracts other than through loans. Thus, in the 1986 technical corrections to the Tax Reform Act of 1984, Congress provided that the cost-recovery-first rules, which generally govern the taxation of life insurance distributions, will not apply to certain distributions occurring within 15 years of the issue date of the contract. (See Joint Committee on Taxation, General Explanation of Technical Corrections to the Tax Reform Act of 1984, p. 107, 1987.)

In short, policy loans and distributions are not the problem with life insurance generally, or with single premium policies in particular. Policy loans and distributions are not the main reason consumers are investing in single premium insurance. Instead, the attraction of single premium life is the accumulation of tax free investment gains. Attacking the distributional features of all insurance contracts, therefore, will not close the single premium loophole.

It will, however, hurt the ability of holders of traditional policies to use their insurance as a flexible means of providing for the security of their family or business. A penalty on policy loans, and a further penalty on distributions, is likely to cripple the market for these traditional products in relation to flexible premium policies. Individuals may hesitate to undertake the long-term commitment of annual premium life insurance if they are hamstrung in their ability to borrow against these policies when unforeseen circumstances make loans necessary to pay the policy premiums, or to cope with family and business emergencies. Others may cancel the annual premium policies that they currently own. Either outcome will severely undermine the social purpose life insurance serves: the protection of families against a provider's untimely death. We submit that this is not the result Congress intends.

Finally, we have also considered the revenue effect of H.R. 3441 because one of the Subcommittee's objectives is presumably to stop the drain on the Federal Treasury caused by single premium life. If H.R. 3441 or a similar proposal is enacted, there should be modest tax savings because those who buy single premium policies for their loan feature will no longer purchase these policies. However, as we have described above, there is good reason to believe that policy loans are not driving the sale of single premium contracts. Consequently, a solution aimed merely at policy loans will not stop the primary group of single premium purchasers -- older, well-to-do individuals -- from placing their discretionary investment dollars into single premium life instead of into taxable investments. Stated differently, H.R. 3441 will harm traditional policyholders, and it will not stop individuals from using the tax incentives for life insurance to shelter income on their investment dollars. Neither the aims of tax policy, nor the Federal Treasury will benefit from this proposal.

POLICY LOAN EXAMPLE

$100,000 net deposit

$302,527 initial face amount

$120,000 total loan proceeds received in cash ($8,000 per year for 15 years)

At age 70 (duration 15):

$243,587 policy cash value

$221,489 outstanding loan amount

$ 22,098 cash surrender value

If surrendered at age 70:

$143,587 taxable gain

$ 42,098 "real" gain to policyholder in cash [$120,000 (borrowed) + $22,098 (surrender value) - $100,000 (premium)]

$ 40,204 tax paid (28% bracket)

$ 1,894 after-tax return on contract

Policy Assumptions -- Issue age 55, 8% interest credited, 8.25% policy loan interest rate, 1970-75 Basic Ultimate Table mortality experience; guaranteed contract values at 4% interest and 1980 CSO mortality.

Chairman **Rangel**. Thank you for your candid testimony, Mr. Clark.

I think that concludes the testimony from this panel.

The Chair would like to entertain questions.

Mr. Flippo.

Mr. **Flippo**. Thank you.

Mr. Clark, the solution you seem to be recommending very strongly is to change the ratio of insurance to premium and you are talking—by doing that, you are talking about a five-year approach.

Mr. **Clark**. That is correct.

Mr. **Flippo**. Why would that work? Why would—could you create a product, a 6-year deal? Why would a 5-year solve the solution?

Mr. **Clark**. I think there are two reasons. First, the NALU solution puts enough life insurance in the product so that it becomes a life insurance product.

It would require, for example, a medical exam. You are not going to take a medical examination to buy a mutual fund.

Second, if you had a 6-year premium, a buyer would have to be patient if, in fact, he were interested in an investment product and he had to wait some 6 years before he could deposit a significant amount into the product. That is why I used the scale of 10 analogy.

I don't know if the NALU solution falls on the scale as a one or a two, frankly, but it will fall somewhere in there because if, in fact, you make single premium a real life insurance product, then the product will no longer be purchased as an investment product and the solution will be effective.

Mr. **Flippo**. Mr. Sharp, I noticed specifically you didn't like the 5-year approach. I believe you rejected that, specifically. Are there any recommendations that you like?

Mr. **Sharp**. I think if there is any recommendation that I have heard about or have seen, it is that if the trickle out of the inside buildup is a problem, I would submit that some form of tax should be appropriate on distributions.

I don't think I would go as as far as Mr. Stark would go. But I think that that is the only area that I see that there is possibly any abuse. My testimony, I think, tries to show that we don't see the abuse; if you, in fact, think you find one—I don't know if anybody has found any abuse yet—that would be the area I would look towards.

Mr. **Flippo**. Thank you.

Thank you, Mr. Chairman.

Chairman **Rangel**. Anyone else seek recognition?

Mr. **Gregg**. Thank you, Mr. Chairman.

I want to go over these numbers again to make sure I have them right.

Mr. Sharp and Mr. Oakes, you both said about 3.7 percent of our cash value is being borrowed or was it 7 percent of cash value being borrowed?

Mr. **Sharp**. I gave two numbers. The percentage of policies with loans was 8.4 percent, I believe. The cash value attributable to loans was 3.7 percent.

Mr. OAKES. Our experience is 10 percent of the policyholders have loans. It amounts to approximately 7 percent of the cash value.

Mr. GREGG. Is there a progressive increase in the amount of borrowing or have those numbers remained flat in the 2 or 3 years you have been writing these things?

Mr. OAKES. Those numbers have gone up and down. I think on average they have remained flat.

Mr. SHARP. I would like to answer on behalf of my own company, Keystone Life. We have sold this product since the latter—the beginning of the last quarter of 1978 to date. The loan numbers that we have parallel the numbers I gave in our testimony.

As to whether they have gone up or down, I think that there is a gradual increase in loan levels. At one point in the early 1980's I remember that we had 1½ percent of cash value being loaned. Now it has crept up to almost the 4 percent level, over almost 10 years.

Mr. GREGG. The last two years as maybe the sensitivity of the marketplace has increased, has there been a jump?

Mr. SHARP. I don't have the exact numbers. I sensed in the last year and half we have had a nominal increase in loans. Yes.

Mr. GREGG. You said 86 percent of our people had income of $50,000 or less? And a fair percentage of those people had incomes of $25,000 or less. Those people are already in the lowest tax bracket. They are not looking for tax shelters?

Mr. EDWARDS. No. We think they are buying life insurance.

Mr. GREGG. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

Mr. Clark, Mr. Oakes, you both come from Springfield. Do you talk to each other?

Mr. CLARK. All the time.

Mr. OAKES. Maybe it is only a Springfield problem.

Mr. MCGRATH. Let me ask you a question I have been asking all day. I have been trying to find one of those policies that was advertised in the paper. I have not yet been able to find one. I wonder if you could describe the difference between the product that you sell and the one that I have seen advertised in the papers?

Mr. OAKES. I would be happy to describe that. In the examples I gave earlier, the cash value after 10 years on three different options for $25,000 would clearly indicate that a single-premium life insurance policy purchased from Monarch is the least desirable option, if you are only looking for cash value in 10 years.

They need the insurance. It would be analogous to trying to buy a residential home as an investment when you didn't need the shelter.

You need life insurance if you are going to buy a single-premium product.

Some of the ads you have seen I think are misleading. Some of the policies that have been offered are in my opinion, irresponsible policies. They advertise zero cost of loans. I think that is unrealistic.

If you went to a bank and wanted to borrow at your CD, I think you would be looking against a 2 percent spread.

Cost of insurance is eliminated for the first year or two. The only way we make money on our policies is to charge for insurance.

The are clearly explicit charges there that amount to well over 2 percent a year for the cost of insurance and expenses.

So while there may be products out there, they are few and far between than I think would appeal to or fulfill the prophecies made in the ads. Ours certainly would not do that, nor have we ever advertised that.

Mr. McGRATH. I guess the problem here is that the solution to the problem, as articulated in H.R. 3441, would not only affect you adversely, but would not solve the problem of what is in the ad?

Mr. OAKES. That is correct.

One of the things that we haven't discussed this morning is the question of the advertising and the ethics involved in the advertising. Maybe we should be appearing before the FTC.

Mr. McGRATH. That is a good question.

If some of the abuses being advertised are misleading, then what is the solution to this misleading advertising and the issuance of some of these policies which are fraudulent? How do we do it.

Mr. OAKES. If history can teach us anything, the bankers went through this problem in the advertising of savings rates at one time. They finally began to police themselves. I think it would be incumbent upon the insurance industry and organizations like ACLI that devote themselves to responsible advertising and truth in advertising.

Mr. McGRATH. I thank the Chairman.

Chairman RANGEL. I want to thank this panel. I am sorry I was not able to hear all of the testimony.

Nice to see you, Mr. Alexander.

The last panel is John Regan, director of the Regan Group; Barbara King, from A.L. Williams Corp.; Oliver W. Horsman, Princeton Information Corp.

The Chair welcomes this panel.

Without objection, your written testimony will appear in the record in its entirety.

We are proceeding under the 5-minute rule.

Mr. Regan.

Mr. JOHN REGAN. Thank you, Mr. Chairman.

STATEMENT OF JOHN D. REGAN, DIRECTOR, INSURANCE COALITION OF AMERICA, INC., PRESIDENT, GENERAL SERVICES LIFE INSURANCE CO., AND PRESIDENT, REGAN GROUP INSURANCE MARKETING, SAUSALITO, CA

Mr. JOHN REGAN. Mr. Chairman, members of the subcommittee, my name is John Regan. I am a founder and director of the Insurance Coalition of America, Inc., which represents the primary interests of consumers who purchase life, health and annuity insurance products. The coalition's members are primarily individual consumers who work in or own the Nation's small and medium-sized businesses.

In addition, I am president and chief executive officer of General Services Life Insurance Co., and chairman of the Regan Group Insurance Marketing.

I appreciate the opportunity to appear before you this morning on behalf of the 4,000 members of the Insurance Coalition of America.

We are opposed to any amendments to existing laws which would have the effect of limiting and/or taxing a buildup of life insurance cash values. We also oppose any changes to adversely affect current laws and regulations concerning employer and employee life insurance plans.

We will present four arguments to support our position.

No. 1, consistency. The public and the industry believed that title II of DEFRA would be in effect for some time. I have been impressed by the verbal commitment of many Members of the Congress and of this committee to provide the marketplace and our industry with certainty in the Tax Code.

Chairman Rostenkowski made remarks to that effect last week, saying he hoped that the 1984 legislation would "settle things for a while as far as the insurance industry was concerned." He spoke to the same insurance group that you addressed at breakfast last week, Mr. Chairman.

We ask that recent legislative changes remain in effect so the industry and consumers can learn their full impact and adjust to them.

No. 2, capital accumulation. The insurance industry has historically played an important role in accumulating capital for our Nation's economy. It is important to note that this is a contribution of additional long-term capital. Consumers generally do not commit their funds to American industry in 20-year bonds; insurance companies do.

Consumers often need to be educated about the benefits of long-term savings represented by life insurance and annuities whereas the immediate gratification of present consumption is obvious. These long-term benefits are brought to the attention of consumers through aggressive marketing by insurance representatives. The capital generated by the insurance industry represents dollars that likely would otherwise have been lost on consumer spending.

It seems to me especially important to cultivate our role in capital accumulation because of the relatively low savings rate of U.S. citizens.

The average Japanese household saves about 16 percent of its income each year, compared to only 4.7 percent for the average American household—nearly four times as much. It is an interesting aside that the Japanese thrift institutions still send collectors with locked wooden boxes to pick up weekly deposits. These collectors are paid on an incentive basis not dissimilar in effect to commission life insurance salespersons in the United States.

The third argument addresses the value of single-premium policies. Although this product is receiving negative attention, it has enabled the life insurance industry to generate substantial additional capital for our economy while giving consumers a way to provide immediate protection for themselves and their families.

Here are two typical examples of single-premium policies.

A grandparent may decide to give a gift of a single-premium policy to a minor child, with the child's parent as the insured. The single-premium on a parent aged 35, for example, might be $5,000.

The amount of life insurance might be in excess of $20,000. When the child reaches age 18, he becomes the owner of the policy and might then receive as much as $12,000 for use as a college fund.

This policy serves two goals. It protects the family against the premature death of a supporting parent and *also provides a college* fund for the grandchild. Yet this free enterprise answer to this family's needs would be precluded if this policy were not available.

To take another example, let's say a 57-year-old man purchases a $20,000 single-premium product. This is, by the way, the typical purchaser of this product. He would buy between $34,000 and $50,000 worth of pure life insurance. When he reaches age 70, the policy would provide supplemental retirement income to him, to the age of 90, of approximately $4,000 per year—of which 75 percent or $60,000 would be fully subject to tax under current law.

This use of single-premium life insurance provides an incentive for those nearing retirement age to provide for their own future, rather than relying on Federal programs to do it for them.

I am certain that the committee would not want to change the law such that the major penalties will fall on American's senior citizens attempting to accumulate or distribute their lifetime savings to supplement their retirement income.

Competitive forces will provide the necessary protections for consumers. Any tax advantage now available through the purchase of life insurance is largely offset by acquisition costs, by the costs of providing pure protection in the event of the insured's death, and by having to meet the interest rate competition from tax-exempt municipals, unregulated bank interest rates, junk bonds, et cetera. No further handicaps are needed.

My last point involves small business. Currently most small businesses are limited by administrative costs and regulatory requirements in their ability to provide fringe benefits for their employees.

However, the small business person is able to provide a benefit analogous to a pension by using cash value life insurance products. To deprive small business owners and their employees of the only currently feasible alternative to expensive pension plans further loads the dice in favor of corporate giants and further restricts the ability of Americans to accumulate capital for their future needs.

There has indeed been some flamboyant advertising about single-premium life insurance, but that doesn't seem to be a satisfactory rationale to destroy a product that is serving so many people and our nation so well. There is a tax advantage to these policies, but it is not being abused. The policies are used, in the vast majority of cases, to allow our citizens to provide for their retirement and to help educate their children and grandchildren. Let us clearly distinguish between abusive advertising and abusive use.

Further, the withdrawal rate from single-premium products is only 1.2 percent annually. The money is not coming out of these policies but is staying in to provide a source of additional capital for our economy.

If attractive insurance options were not available, the money could be spent on vacations and consumer goods instead of being reinvested in our economy.

We ask the committee not to make further changes in the laws affecting our industry until we have had a chance to stabilize under the new rules created in 1984 and 1986. Indeed, let's review single-premium purchases, as opposed to advertising, for 6 months, 12 months, 18 months, whatever, to reconfirm that it is being properly used.

Today, when the average purchaser is age 57 and the average single premium is $20,000. it is being properly used; let's not fix something that is not broken.

Finally, I would suggest we substitute the words "additional long-term savings" for "investment" when we describe the part of a life insurance contract being discussed here today.

Mr. Stark questions when there is too much investment. I question if there can ever be too much savings. It would seem to follow, therefore, that the real impact of the proposed amendments would not be more tax revenue; it could be more Japanese TVs, VCRs and motor scooters purchased by consumers, and more foreign ownership of U.S. factories, offices and farms by institutions that represent offshore capital buildup.

I thank you for the opportunity to present these views today, and I welcome your questions.

[The statement of Mr. John Regan follows:]

TESTIMONY OF JOHN D. REGAN
FOUNDER AND DIRECTOR
INSURANCE COALITION OF AMERICA, INC.

before the
Subcommittee on Select Revenue Measures
House Ways and Means Committee

March 15, 1988

Mr. Chairman, and members of the Subcommittee:

My name is John D. Regan. I am founder and director of the Insurance Coalition of America, Inc., which represents the interests of those who purchase and sell life, health, and annuity insurance. The coalition's members are primarily individual consumers who work in or own the nation's small and medium-sized businesses. In addition, I am president and chief executive officer of General Services Life Insurance Company and the Regan Group Insurance Marketing.

I appreciate the opportunity to appear before you this morning to discuss life insurance and the interests of policy holders and the American economy. The 4,000 members of the Insurance Coalition of America are opposed to any amendments to existing laws which would have the effect of limiting and/or taxing a buildup of life insurance cash values or of adversely affecting current laws and regulations concerning employer/employee life insurance plans.

We will present four arguments to support our position.

Consistency

First, the industry believed that Title II of the Deficit Reduction Act of 1984 established policies that would be in effect for some time. I have been impressed by the verbal commitment of many members of the Congress and of this committee to provide the marketplace, and our industry, with certainty in the tax code so we know the rules under which we must operate.

Chairman Rostenkowski made remarks to that effect just last week in a speech before the Association for Advanced Life Underwriting, saying that he also had hoped that the 1984 legislation would "settle things for a while as far as the insurance industry was concerned." Yet as recently as 1986, after extensive negotiations, the life insurance industry agreed to various legislative compromises (such as taxation of annuities on a last in/first out basis), increased taxation of the companies themselves, etc.

We support the concept of certainty in the tax code to allow the recent legislative changes to remain in effect long enough for the industry to adjust to them and learn their full impact.

Capital accumulation

Secondly, the insurance industry has historically played an important role in the accumulation of capital for our nation's economy. Once again, Chairman Rostenkowski recognized the important contribution that our industry makes to our nation's economy by stating that he supports the favorable tax treatment of life insurance.

It is common knowledge that the U. S. faces a crisis due to the low level of savings by its citizens. For example, the average Japanese household saves about 16 percent of its income each year compared to only 4.7 percent for the average American household. [1]

The contribution to the nation's capital build-up by the insurance industry is indeed a contribution of additional capital. Consumers generally need to be educated about the benefits of long-term savings represented by life insurance and annuities whereas the immediate gratification of present consumption is obvious. These long-term benefits are brought to the attention of consumers through aggressive marketing by insurance representatives. Thus, the capital generated by the insurance industry is significant additional capital -- dollars that likely would otherwise have been lost on consumer spending (to purchase such things as Japanese T.V.'s and Japanese autos).

However, beginning in the 1950's, a number of factors converged to cause the insurance industry's role in capital accumulation to decline. Among those factors were:

- o inflationary interest rates that attracted capital to other sources,
- o laws that precluded a quick match against large, established, fixed dollar investments underlying life insurance,
- o the availability of other tax advantaged investments,
- o deregulation of the banking and securities industries.

Current life insurance products, such as "single premium" products, belatedly have enabled the life insurance industry to start to regain part of its traditional role or market share.

But other factors continue to place restrictions on the industry's role in serving as a reservoir of capital for the American economy. For example, to enjoy status, for tax purposes, as "life insurance," a contract must comply with various DEFRA [2] tests. The consequence is that in all age groups a substantial part of any premium must be used to pay for pure "risk" or pure life insurance protection. These tests, arduous as they are, should not be further expanded to the detriment of the nation's capital buildup.

Current life insurance products, including single premium products, already are self regulated by free economic competitive factors since the industry today must:

- o pay for the costs of collecting capital, (i.e., commissions),
- o pay for the cost of pure protection, or "risk," as required by DEFRA,
- o still provide a competitive rate of return on resulting cash values.

In other words, any "tax advantage" now available through the purchase of life insurance is largely offset by acquisition cost, by the costs of providing pure protection in the event of the insured's death, and by having to meet interest rate competition from tax exempt municipals, unregulated bank interest rates, junk bond high interest credits, etc. No further handicap is needed. Competitive forces will provide the necessary protections as the life insurance industry moves toward its traditional role in accumulating capital for the nation while providing protection for individual citizens.

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[1] It is an interesting aside that Japanese thrift institutions still send collectors, with locked wooden boxes, to pick up weekly deposits. These collectors are paid on an incentive basis not dissimilar in effect to commissioned life insurance sales persons in the U.S.

[2] The definition of life insurance first introduced in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and later expanded in the Deficit Reduction Act of 1984. (DEFRA)

Single premium life

The third argument addresses a particular type of life insurance that is getting much negative attention. That type of life insurance is called "single premium" because the life insurance policy (as defined within DEFRA standards) can be paid for with one "single" payment. Obviously, the amount of that payment will differ depending on the age of the insured and the amount of insurance to be purchased. Here are two typical ways in which the policies are used:

o A grandparent may decide to give a gift of a single premium policy to a minor child, with the child's parent as the "insured." In this case, the "single premium" on a parent aged 35, for example, might be $5,000, and the amount of life insurance might be as high as $21,000. When the child reaches age 18, he becomes the "owner" of the policy and might then receive as much as $12,000 for use as a college fund. This policy serves two goals: It protects the family against the premature death of a supporting parent and also provides a college fund for the grandchild. Yet this free enterprise answer to this family's needs would be precluded if this policy were not available.

o To take another example, let's say a 57 year old man purchases a $20,000 single premium life product. He would buy between $34,000 and $50,000 worth of pure life insurance (for example, to the benefit of his spouse). When he reaches age 70, the policy would provide supplemental retirement income to him to age 90 of approximately $4,000 per year.[3] This use of single premium life insurance provides an incentive for those reaching retirement age to provide for their own future, rather than relying on federal programs to do it for them. The availability of this type of policy is an important component in the insurance agent's portfolio. It would be unfortunate if the many persons who could benefit from it were denied that opportunity because of a few abuses.

These two examples are typical. Statistics indicate that the average age of the purchaser of single premium life insurance is about 57; the average "single premium" is about $20,000.

I am certain that the committee would not want to change the law such that the major penalties will fall on America's senior citizens attempting to accumulate or distribute their lifetime savings to supplement retirement income.

Small business

My fourth point involves small business.

Currently, most small businesses are limited by administrative costs and regulatory requirements in their ability to provide fringe benefits for their employees. For example, the small employer who attempts to establish pension plans faces a substantial burden in extensive regulations and requirements that must be met by the sponsor of such plans. Just the costs of required record keeping and annual actuarial calculations preclude a small business from adopting tax advantaged pension plans. Further, many other "fringe benefits" in reality are readily available only to large employers that have bargaining power with the supplier of such benefits.

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[3] Under current law, withdrawals exceeding basis are fully subject to income tax.

However, the small business person is able to provide a fringe benefit program, analogous to a pension, for his or her employees by using group, cash value life insurance products. Such group policies are administered by the life insurance company issuing the policy and the employee certificates, at rates the small business owner can afford. Under current laws and regulations, some of the benefits of such a plan are similar to those otherwise available only through far more expensive pension plans. To deprive small business owners, and their employees, of the only currently feasible alternative to expensive pension plans, further loads the dice in favor of corporate giants -- and further restricts the ability of Americans to accumulate capital for their future needs.

It should be noted that these plans often allow small businesses to achieve better results for their employees than could an individual employee purchasing comparable forms of individual, single premium insurance. This follows because:

o group insurance is not subject to the same "anti-rebate" restrictions that preclude bargaining between the seller of insurance and the purchaser of insurance as to the "load" or other commission costs entailed in such purchase; and

o an insurance carrier might be willing to provide for simplified acceptance in small group cases that would enable all participants to avoid "rating" that otherwise could be applicable to the individual purchasers.

It is not uncommon, for example, for a 17-employee group to receive its insurance at a 10% commission charge instead of individual charges substantially in excess of that amount.

I understand that this committee and the administration are seriously reviewing proposals to change the law as it affects our industry, and particularly single premium life insurance. As someone who is out there in the marketplace every day, I assure you that there are valid and compelling reasons why the law should be left as it is. In the vast majority of cases, the product is being used as it was intended, namely as a protected way of saving and distributing retirement income. There has been some flamboyant advertising about single premium life insurance, but that does not seem to be a satisfactory rationale to destroy a product that is serving so many people so well. There is a tax advantage to these policies, but it is not being abused; the policies are used in the vast majority of cases to allow our citizens to provide for their retirement and to help educate their children and grandchildren.

Further, the withdrawal rate from single premium products is only 1.2 percent annually. The money is not coming out of these policies, but is staying in to provide a source of capital for our economy.

Life insurance gives people the option of protecting themselves now and their families in the future while contributing to a reservoir of funds that helps our nation's economy grow. If attractive insurance options were not available, the money could be spent on consumer goods, vacations, and other commodities instead of being reinvested in our economy.

It would seem to follow, therefore, that the real impact of the proposed amendments would not be more tax revenue; it could be more VCR's, motor scooters, and foreign ownership of factories, offices and farms by institutions that represent offshore capital buildup.

In closing, I again emphasize my request to the Committee not to make further changes in the laws affecting our industry until we have had a chance to stabilize under the new rules created in 1984 and 1986 and to learn their full impact before revisions are considered.

I thank you for the opportunity to present these views today, and I welcome your questions.

Chairman **Rangel**. The Chair recognizes Mrs. King.

Mrs. **King**. Thank you.

STATEMENT OF BARBARA T. KING, SENIOR EXECUTIVE VICE PRESIDENT, A.L. WILLIAMS CORP., ACCOMPANIED BY KEVIN KING, GENERAL COUNSEL

Mrs. **King**. I am Barbara T. King, senior executive vice president of the A.L. Williams Corp. and a member of the board of directors. I am accompanied today by Kevin King, our general counsel.

The A.L. Williams sales force is a nationwide network of independent business men and women marketing financial services in 49 States and all of the provinces of Canada. We have over 180,000 licensed representatives. We promote conservative family financial planning and saving for retirement. We recommend buy term and invest the difference, that is, buy only term life insurance coupled with a separate savings plan.

While we do not market single-premium life insurance, we commend the committee for your efforts to change the rules regarding the taxation of single-premium policies. In our opinion, single-premiums are nothing more than a tax-advantaged investment tool masquerading as life insurance.

Life insurance is intended to protect families by providing a financial hedge, should a family lose its breadwinner. When life insurance becomes a haven for tax-dodgers and a means for the wealthy to avoid their fair share of taxes, then Congress should take action.

GAO found that 45 percent of single-premium buyers are age 60 and over. Considering the high investment component and the low death benefit ratio, we believe that these individuals are quite simply looking for a way to avoid paying taxes on investment income.

Because of liberal distribution rules and the tax-deferred nature of single-premium products, they are competing unfairly with legitimate investment products. A municipal bond can't compete with SPs, nor can a certificate of deposit, nor an annuity, nor a Treasury note.

By overlooking this loophole in the 1986 Tax Reform Act, Congress inadvertently made a generous gift to a small privileged segment of society. Congress almost addressed this issue last fall. The Treasury wanted to close the loophole and so did participants in the historic deficit reduction conference. At the last minute the conference decided to postpone any action until next year, pending a hearing.

Well, Mr. Chairman, this is "next year." The deficit persists, and reducing it is a mammoth task. But even if you were facing a surplus, SPs would still be a blatant abuse that cries for correction.

When we first heard about the Stark-Gradison bill, we joined them in their efforts to rectify this problem. At first the insurance industry opposed not only their legislation but also the intent and spirit of their reform initiative.

We believe it is important for our company and the industry to constructively help resolve this problem. The question is simply how.—

House bill 3441 has certainly stimulated the interest in the industry to reexamine its position on single-premiums. We not only applaud the sponsors' efforts, but we also believe this bill represents the right way to treat loans and distributions.

We have heard, however, the concern that House bill 3441 goes too far, and that modification would be required to secure the votes for passage. We stand ready to work with Congress to pass a bill that is focused on investment-oriented products alone, meaning products that fail to maintain an appropriate ratio of death benefits to premiums.

Therefore we propose a 10/10 plan. This plan would amend House bill 3441 to narrow its application to policies which do not maintain a minimum ratio of death benefit to premium for 10 years; 10/10 would retain all other parts of House bill 3441, including the 10 percent tax penalty on distributions.

The industry proposals we have seen are long on rhetoric but short on impact. One proposal provides an exception for nontaxable withdrawals for education and medical expenses, a loophole so large it is ineffective as a solution.

Another proposal would amend the definition of life insurance to exclude certain contracts by establishing an increased ratio of death benefits to premium for a minimum of 5 years. This proposal does not solve the problem. To be meaningful, it should be a 10-year test. Any policy which fails the 10-year test is really an investment and not a life insurance policy.

If Congress does not stop these abuses, you can be sure that the market will be inundated with SP products and, whatever the revenue drain in the past, there will be a dramatic increase, indeed a hemorrhage in revenue loss in the immediate future. Failure to act now is tantamount to putting the congressional stamp of approval on these abuses.

That concludes my statement. Thank you.

Chairman RANGEL. Thank you, Mrs. King.

[The statement of Mrs. King follows:]

March 15, 1988

WRITTEN TESTIMONY OF THE A. L. WILLIAMS CORPORATION

I am Barbara T. King, Senior Executive Vice President of the A. L. Williams Corporation, and a member of the Board of Directors.

The A. L. Williams sales force is a nationwide network of independent businessmen and women marketing financial services and products in 49 states, the District of Columbia, various territories and all of the provinces of Canada. There are over 180,000 licensed salespersons --- 40,000 of which are full time.

In our marketing philosophy we stress conservative family financial planning and saving for retirement. In life insurance, we recommend Buy Term and Invest the Difference, that is, buy only term life insurance coupled with a separate savings plan. Those who follow this principle will often find that their needs for death benefit protection reduce over time. We call this the Theory of Decreasing Responsibility.

We sell only term insurance, and sold, for Massachusetts Indemnity and Life Insurance Company (MILICO), over $81 billion in life insurance coverage in 1987. As a result of our sales, MILICO now has in force over $210 billion of coverage insuring over 1.5 million families against the premature death of the breadwinner. Although we do not market single premium life insurance, or any whole life insurance, we believe strongly that Congress should act to change the rules regarding the taxation of single premium policies. In our opinion, SPs are nothing more than an investment tool masquerading as life insurance.

From New York to California, insurance agents are touting the new SP policies to wealthy clients as "the best financial vehicle ever created."

Exhibit A is a copy of a January, 1987 advertisement of the Wall Street Journal printed by Integrity Life Insurance Company. The spirit of this advertisement goes to the heart of the issue at hand. Any product that promises returns to the living is inconsistent with the notion of life insurance, which is intended to provide financial benefits to the beneficiary after the death of the owner. The ad actually states "Of course, it's very commendable to provide for your children. But with an Integrity Single Premium Life Insurance Policy you can provide for yourself." The advertisement further discloses that the owner can borrow against the policy at no cost, in particular, no adverse tax consequences, and, further, "you never have to pay back any of the money."

This product sounds too good to be true, and it wouldn't be true were it not subsidized by the federal government.

A full page ad in the Los Angeles Times, Exhibit B hereto, boasts: "Pay alimony at no cost whatsoever. Support any relative with pre-tax dollars." "Give money to charity at a profit. Recover capital gains taxes paid."

Exhibit C attached hereto is a copy of a brochure issued by the Executive Life Insurance Company, explaining the highlights of its single premium life insurance policy entitled, "Explorer Express." The company has chosen to illustrate the merits of its product, not by how much a death benefit can be purchased for how little premium, but rather, by comparing it to alternative investments, including deferred annuity, municipal bonds, certificate of deposit, money market, and treasury bonds. According to the illustration, single premium whole life is the best investment vehicle available. The center panel, with the colored bar chart, illustrates not premiums, death benefits, settlement options, etc., but how the Internal Revenue Code permits interest credited on the cash value to accumulate "tax deferred." The illustration compares an accumulation at 8 1/2 percent with a zero percent tax bracket as well as a 30 percent tax bracket to show that after 25 years almost double the savings without tax results.

The mortality paragraph is also interesting:

> "We guarantee there will be no mortality charge for the fir[illegible] year. After the guarantee period, the company will declare rates for any applicable mortality charge. Currently, the company projects zero mortality charge for the life of the policy." (Emphasis added.)

Can a life insurance company give away the cost of providing the death benefit? Missing from the brochure are premium rates.

Life insurance is intended to protect families by providing a financial hedge against the day when a family may lose its breadwinner. When life insurance becomes a haven for tax dodgers, a means for the wealthy to avoid their fair share of the tax load, a tax free way to finance fast cars and exotic vacations, Congress should take another look.

A GAO report (October 16, 1987) found that between 1984 and 1986, single premium life sales grew by 318 percent -- up from $1 billion to over $4.3 billion.

By comparison, ordinary premium sales grew only 13.3 percent -- from $8.3 billion to $9.4 billion. The figures for 1987 aren't in yet, but until Congress started looking at this problem last fall, SP sales were headed toward $10 billion. That is an estimated 250 percent increase in one year!

GAO also found that most SP buyers are age 60 and over. These individuals are, quite simply, looking for a way to avoid paying taxes on investment income.

A municipal bond can't compete with SPs.
A certificate of deposit can't compete with SPs.
An annuity can't compete with SPs.
Treasury notes can't compete with SPs.

By overlooking this loophole in the 1986 Tax Reform Act, Congress inadvertently made a generous gift to a small privileged segment of society.

Every time one of these policies is sold, you and I, and every other taxpayer loses. It has been estimated that over $100 million is lost annually to the IRS in taxes avoided by the purchase of SPs. That is a significant sum to a nation searching desperately for ways to reduce the Federal deficit.

Congress almost addressed this issue last fall. The Treasury wanted to close the loophole. Many participants in the deficit reduction package conference wanted to include a SP solution in the bill. At the last minute, the conference decided to postpone any action until next year.

Well, Mr. Chairman. This is "next year." The deficit persists, and reducing it is a mammoth task. But, Mr. Chairman, even if you were facing a $100 BILLION SURPLUS, SPs would still be a wrong that cries for correction.

Now, a few comments about the proposals that have come to our attention prior to these hearings.

First, H.R. 3441.

We applaud the efforts of Congressmen Stark and Gradison because they had the courage and conviction to address this issue and because we believe H.R. 3441 represents the right way to treat loans and other distributions. They have certainly stimulated the industry to reexamine its position on SPs.

We have heard Members of Congress express the concern that H.R. 3441 goes too far, and that a modification would be required to secure the votes for passage. We stand ready to work with this committee to assure passage of a bill that is more closely focused on investment oriented products alone, to-wit: products that fail to maintain the appropriate ratio of death benefit to premium for a sufficient time.

We do not propose to change the Section 7702 definition of life insurance, but rather merely to describe those policies which are subject to the HR 3441 tax on loans and other distributions and the 10% penalty tax on distributions prior to age 59-1/2.

We believe that the "amount paid in test", as defined in the NALU draft proposal entitled "NALU Industry Committee on Product Tax (Single Premium Life Insurance)", calculated for a 10 year period, instead of a 5 year period, is appropriate for this purpose.

A 10 year application of the "amount paid in test" will mandate a large enough amount of death benefit protection so as to render the product truly a life insurance policy and not principally as an investment. The table below illustrates this concept and provides support for our belief in a 10 year standard.

INTERNAL RATES OF RETURN

SINGLE PAYMENT
AS PER EXAMPLE 3, APPENDIX B (GROSS INTEREST/10% LOAD) IN NALU DRAFT PROPOSAL

POLICY ISSUE AGE	PERIOD FOR AMOUNT PAID IN TEST	POLICY YEAR	INTERNAL RATE OF RETURN
35	5	10	7.56%
		15	8.18
		20	8.46
35	10	10	4.22
		15	5.92
		20	6.76
35	15	10	1.77
		15	0.56
		20	2.68
55	5	10	5.22
		15	6.41
		20	6.97
55	7	10	1.32
		15	3.77
		20	4.97
55	10	10	-25.30
		15	-15.31
		20	- 9.87

To deter using a single payment policy principally as an investment, the period for the "amount paid in test" should vary from about 15 years at juvenile issue ages to about 7 years at ages over 50. In the interests of simplicity, we propose a uniform 10 years.

Second, the industry proposals we have seen are long on rhetoric but too short on impact. For example, an NALU Draft proposal would amend the definition of "life insurance" to exclude life contracts that are actually investments, by establishing an increased ratio of death benefits to premium for a minimum of 5 years. This proposal does not solve the problem.

To be meaningful, the 5-year test should be a 10-year test for the reasons noted earlier. Any policy which fails this 10- year test is really an investment and not a life insurance policy.

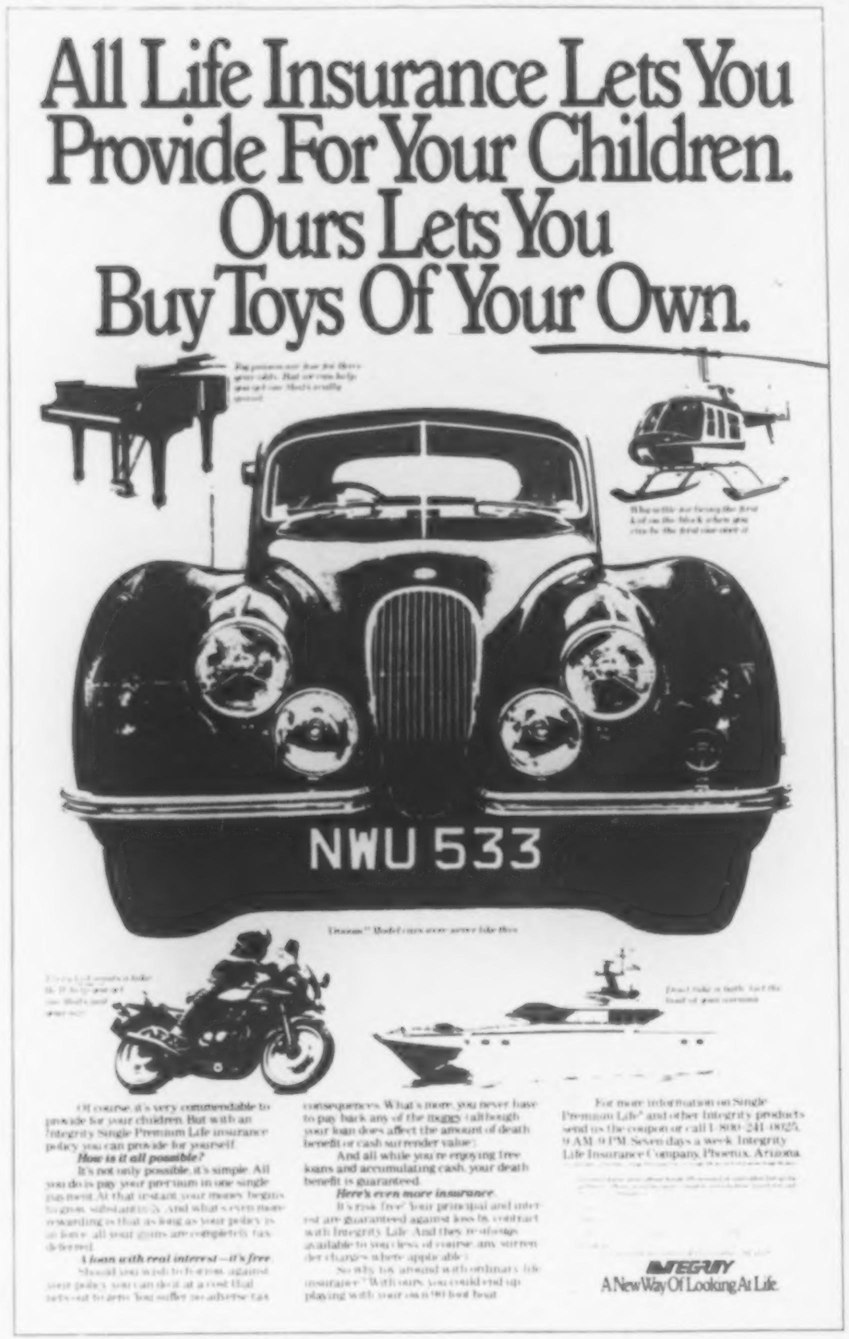
A third proposal we have seen is recognition of the problem, but the solution offered has too much window dressing. For example, this draft provides an exception for non-taxable withdrawals for education and medical expenses, an exception so large that the proposal is rendered ineffective as a solution. Also, it should contain a penalty tax on distributions before age 59 1/2.

In short, this proposal is poor tax policy.

Mr. Chairman.

We strongly believe life insurance should be life insurance -- not an investment tool. We believe that Congress never intended for life insurance to become a tax dodge. To correct the SP inequity, Congress must act now. If Congress does not close the loopholes which exist, you can be sure that the market will be awash in new SP packages before you can blink. Failure to act now is tantamount to putting the Congressional stamp of approval on this outrageous abuse.

Whatever the revenue drain in the past, there will be a dramatic increase, indeed, a hemorrhage in revenue lost in the immediate future. This is bad tax policy and unfair to the millions of Americans who pay their fair share of taxes.



All Life Insurance Lets You Provide For Your Children. Ours Lets You Buy Toys Of Your Own.

Why settle for being the first kid on the block when you can be the first one over it
Dinky™ Model cars were never like this
NWU 533

Of course, it's very commendable to provide for your children. But with an Integrity Single Premium Life insurance policy you can provide for yourself.

How is it all possible?

It's not only possible, it's simple. All you do is pay your premium in one single payment. At that instant, your money begins to grow substantially. And what's even more rewarding is that as long as your policy is in force, all your gains are completely tax deferred.

A loan with real interest—it's free.

Should you wish to borrow against your policy, you can do it at a cost that nets out to zero. You suffer no adverse tax consequences. What's more, you never have to pay back any of the money (although your loan does affect the amount of death benefit or cash surrender value).

And all while you're enjoying free loans and accumulating cash, your death benefit is guaranteed.

Here's even more insurance.

It's risk free! Your principal and interest are guaranteed against loss by contract with Integrity Life. And they're always available to you (less, of course, any surrender charges where applicable).

So why toy around with ordinary life insurance? With ours, you could end up playing with your own 90 foot boat.

For more information on Single Premium Life® and other Integrity products send us the coupon or call 1-800-241-0025, 9 AM-9 PM. Seven days a week. Integrity Life Insurance Company, Phoenix, Arizona.

INTEGRITY
A New Way Of Looking At Life.

EXHIBIT 3

TAX-FREE MONEY* WITH THE BEST FINANCIAL VEHICLE EVER CREATED

The Exciting... SP Single Premium Whole Life

Tax Sheltered Earnings That You Can Spend

Better than a CD, Treasury Bill, Money Market Fund, Zero Coupon Bond, Annuity or Municipal Bond.

Principal and 7½-9% Tax-Free Money guaranteed 100% by over 30 leading U.S. life insurance companies with assets up to 100 billion dollars.

What is an SP?

It's the most dynamic, revolutionary, and yet safest instrument in the financial marketplace. A totally flexible and versatile vehicle offering almost unbelievable benefits and tax advantages!

That's the SP: Single Premium Whole Life Insurance Policy.

But it is much more than just an insurance policy!

In a sense, it is a tax-free Certificate of Deposit, Zero Coupon Bond, Money Market Account, T-Bill, Annuity, Municipal Bond, and a fully paid-up life insurance policy all rolled into one contract! A contract where your SP will:

- produce a higher yield than is offered by each of the above.
- give you a yield income tax-free
- never decrease the value of your growing cash accumulation (as zero-coupon bonds do when interest rates rise)
- never lose a cent of your original single payment (as you can with municipal bonds)

The Incredible Advantages of this Dynamic and Totally Safe New Concept

One Payment

You can make a single payment, as you would for a CD, T-Bill, Bond, etc. In any amount from $5,000 to $5,000,000. You get a completely paid-up insurance policy for a full lifetime, written by a major life insurance company. You never pay another dollar! You also get access to a whole world of tax advantaged opportunities.

No Hidden Charges

Unlike many mutual funds, the SP carries no front-end load or sales charges. Nor are there ever any yearly administrative or management fees. There is a charge for early surrender. With the SP, 100% of your deposit goes to work immediately for you.

Guaranteed Tax-Free Money Based on Current Law

Each year, your SP insurance company offers a competitive rate of interest on your principal. Currently this ranges from 7½-9%, for 1-7 years, depending on the company. And this interest compounds tax-free, just like an Annuity or a tax-free Zero Coupon Bond. At the end of each contract year, you can receive your SP interest accumulation for that year, tax-free under current law. Or, you can leave it in and let it compound for another year.

Liquidity

The initial attraction of the SP is the accumulation of tax-deferred interest, but the real beauty of the single-premium whole life policy lies in its liquidity. Your SP accumulation can be withdrawn anytime you wish with a no-cost, tax-free loan! Also, you can withdraw up to approximately 90% of your SP principal whenever you want, through a low minimum 2% interest cost loan! And you never have to pay back any withdrawal, whether it is an interest accumulation loan or a principal loan.

BARRY KAYE ASSOCIATES
Founded [illegible]
1840 Century Park East
Los Angeles, California 90067
(213) [illegible]

Tax Free Income • Estate Analysis • Deferred Compensation Plans • Pension Plans • Annuities • Business, Life, Health and Group Insurance

Tax-Free Death Benefit

You receive an income tax-free death benefit. It can be anywhere from 100% to 500% of your principal. (The younger you are, the larger the benefit. If you wish, you may have the insurance placed on another family member). And the principal, any accrued interest-not withdrawn as tax-free income, and the death benefit all transfer to your heirs with no income tax and no probate costs. (You can avoid estate tax by leaving it to your spouse).

Privacy

Your investment is private. No 1099 form is reported to the I.R.S. as long as you keep your SP plan in force. And there is no Social Security effect (your tax-free income does not count against the possible taxation of your Social Security payments).

Safety

The Single Premium Whole Life Policy is sold today by over 30 major U.S. insurance companies, many of which merit the highest rating of A+ from A.M. Best Co., an independent rating service. These underwriting organizations put their multi-billion dollar resources and integrity fully behind the SP.

The SP Is A Conservative Product With Versatile and Creative Applications

- Pay for your child's or grandchild's education on a pre-tax basis.
- Support any relative with pre-tax dollars.
- Give money to charity at a profit.
- Pay alimony at no cost whatsoever.
- Buy real estate at a discount.
- Recover taxes on your pension benefits.
- Recover business or investment losses.
- Recover capital gains taxes paid.
- Pay debts with pre-tax dollars.
- Pay for life insurance with pre-tax dollars.
- Eliminate all life insurance premiums.
- Have your estate taxes paid for you.

...and many more

THE NEW TAX ACT, DOES IT AFFECT THE SP?

Absolutely not. In no way does the new tax act impact on the SP. All tax-free and other benefits and advantages of the SP remain intact.

BARRY KAYE ASSOCIATES is a national financial marketing and planning firm established in 1962, specializing in the life insurance field. It represents many United States multi-billion dollar insurance companies with assets up to 100 billion dollars. During the past 24 years Barry Kaye Associates has created over $1 billion of potential assets for clients all over America.

To purchase your SP or for more information on how the SP can be creatively used to your advantage.

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Toll Free / Outside California [illegible] • In California [illegible]

OR MAIL THE COUPON

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1840 Century Park East, Los Angeles, California 90067 • (213) [illegible]

Dear Sir: Yes, I would like more information on the SP and how it beats any Money Market, T-Bill, Zero Coupon, or CD with more tax advantages than any Municipal Bond or Annuity. No obligation, of course.

Name ______

Address ______ Phone ______

City ______ State ______ Zip ______

---

*Via policy loans. Under current law, amounts received as policy loans are not taxable as income as long as the policy remains in force.

Loans are charged at only 6% per year. If the loan is equal to or less than the earnings in the contract, Executive Life currently credits 6% on the amount borrowed. *The net cost of such a loan is currently 0%.* This net cost may never be greater than 2%, even if the Company lowered the declared rate to the minimum 4% allowed in the contract. For amounts borrowed in excess of the earnings in the contract (borrowing of principal), 4% will be credited, making the net cost to the policyowner only 2%.

Mortality Rates

We guarantee there will be no mortality charge for the first year. After the guarantee period, the Company will declare rates for any applicable mortality charge. Currently the Company projects zero mortality charge for the life of the policy.

Administrative Information

Application

Use application 3123. Use application 1872 for a loan.

Issue Age

0-75

Simplified Underwriting

For details on simplified underwriting refer to the separate Express Underwriting Guidelines card #1986.

Single Premium Table

Issue Age	Minimum Limit	Maximum Limit
0-20	5,000	40,000
21-30	10,000	100,000
31-40	10,000	150,000
41-50	10,000	250,000
51-60	10,000	450,000
61-65	10,000	275,000
66-75	10,000	200,000

Highlights of the Explorer+Express:

- One Payment
  No future premiums or "calls"
- Safety
  Money is fully and contractually guaranteed
- High Return
  Competitive interest rates
- No Market Risk
  Funds and earnings are guaranteed
- Tax Deferred Accumulation
  No tax while cash values accumulate
- Guaranteed Availability of Loans
  Contractual cash values available
- Low or No-Interest Loans
  Net 2% on principal, 0% (zero!) on earnings!
- Tax-Free Death Benefits
  Funds receive "stepped up cost basis" treatment
- No Annual Fees or Charges for Administration
  All principal earns interest from the start
- 100% Money Back Guarantee on the Principal
  Ten day free look

Provided by Form 118/121

Executive Life Insurance Company
11444 W. Olympic Boulevard
Los Angeles, CA 90064 (213) 312-1000

POSTAL ADDRESS
P.O. Box 6090
Inglewood, CA 90312-6090

An A+ (Superior) A.M. Best rated company

1983 11 8

Explorer Plus℠

Explorer∔Express

In the crowded financial arena of our times, consumers look for three basic elements: 1) Safety, 2) Return, and 3) Tax Advantages. Increasingly, the answer is found in single premium whole life.

Combining the best features of traditional life insurance, annuities, C.D.'s, municipal bonds, treasury bonds, and money market funds, a single premium life plan provides the safety of money deposited with a multi-billion dollar life insurance company, high current interest rates, and the unique tax advantages available only through life insurance products.

	TAX-DEFERRED ACCUMULATION	NON-TAXABLE LOANS OR DISTRIBUTIONS	ADDITIONAL TAX-FREE DEATH BENEFIT	SAFETY OF PRINCIPAL	LIQUIDITY	LONG-TERM RATE GUARANTEE	LOW MARKET RISK
SPWL	YES	YES	YES	VERY GOOD	VERY GOOD	VERY GOOD	YES
DEFERRED ANNUITY	YES	NO	NO	VERY GOOD	VERY GOOD	VERY GOOD	YES
MUNICIPAL BONDS	YES	YES	NO	VERY GOOD	VERY GOOD	Excellent	NO
CERTIFICATE OF DEPOSIT	NO	NO	NO	Excellent	GOOD	GOOD	YES
MONEY MARKET	NO	NO	NO	VERY GOOD	Excellent	POOR	YES
TREASURY BONDS	NO	NO	NO	VERY GOOD	Excellent	Excellent	NO

Executive Life, known as the innovator of modern single premium products, now introduces its new Explorer∔Express plan.

Explorer∔Express is a single premium whole life product with a one-year interest rate guarantee, no cost for mortality for the first year, and simplified underwriting.

The safety of your money is assured. The policy is guaranteed by contract and protected by the financial strength of Executive Life Insurance Company, a legal reserve life insurance company with assets of over 9 billion dollars and insurance-in-force of over 40 billion dollars.

Executive Life Insurance Company is rated A+ (Superior) by A.M. Best Company, insurance analysts since 1899. A.M. Best's highest rating has been awarded to Executive Life continuously since 1978. A+ (Superior) indicates the Company's relative strength in the insurance industry and reflects its operating performance and financial strength.

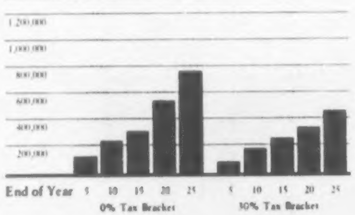
Here's How it Works:

Tax Advantages

Under current tax law, interest credited on the cash value accumulates *tax deferred*. The cash value accumulation is not taxed until withdrawn or the contract is surrendered. This means the full amount remains in place working for you rather than taxes being deducted before interest compounds.

The benefit of deferring taxes on interest as earned is shown in the hypothetical illustration. This illustration assumes a yearly interest rate of 8½% and no withdrawals. Compare the accumulation of $100,000 on a tax deferred basis, assuming a 30% federal and state combined tax bracket.

Accumulation at 8½%



Policy Year	0% Tax Bracket	30% Tax Bracket
5	150,366	133,507
10	226,098	178,242
15	339,974	237,966
20	511,205	317,701
25	768,676	424,154

It is easy to see how cash value grows faster because the interest earned is not reduced by taxes.

Additional tax advantage occurs when the policy, at the insured's death, is paid out as an income tax-free death benefit. Outstanding loans are paid from the proceeds, and the remainder is paid to the named beneficiary *with no liability for either state or federal income tax payment.*

Guarantees

The initial declared interest rate is guaranteed for one year on the Explorer∔Express. The interest credited, following the guarantee period, is determined by the Company's experience, taking into account current market conditions, and is declared annually. The interest rate for years two through ten will be the same as the first year unless Moody's Corporate Aaa Bond Yield index falls one percent or more below the first year's declared rate. In that event the Company will declare the same rate as is credited to new sales but not lower than the index rate minus one percent. The declared interest is guaranteed *never* to fall below 4%.

Interest Rates and Administrative Charges

Executive Life Insurance Company charges no start-up fee or annual administrative charges. There is no reinvestment strategy required on the insured's part, as cash value accumulation is automatically reinvested. An annual statement is issued showing values, interest credited, loans, withdrawals, and death benefit.

Due to a high current interest rate and no current charge for the life insurance protection, the growing cash value within our Explorer∔Express plan is competitive with any other secure financial alternative available.

Surrenders

All or any part of the policy may be surrendered at any time. A partial surrender will result in a proportionate reduction of all other values and benefits of the policy. If the policy is surrendered during the first nine years, a surrender charge will be deducted from the cash value. The surrender charge diminishes as follows according to the percentage of cash value:

Surrender in Policy Year	1	2	3	4	5	6	7	8	9	10 & thereafter
Surrender Charge Percentage	10	10	10	10	10	8	6	4	2	0

Advantageous Loans and Rates

Under current law, the principal or the interest earnings may be borrowed from the Explorer∔Express plan without incurring any income tax liability. Life insurance policy loans are not included as taxable income, just as car loans are not taxable.

	TAX-DEFERRED ACCUMULATION	NON-TAXABLE LOANS OR DISTRIBUTIONS	ADDITIONAL TAX-FREE DEATH BENEFIT	SAFETY OF PRINCIPAL	LIQUIDITY	LONG-TERM RATE GUARANTEE	LOW MARKET RISK
SPWL	YES	YES	YES	VERY GOOD	VERY GOOD	VERY GOOD	YES
DEFERRED ANNUITY	YES	NO	NO	VERY GOOD	VERY GOOD	VERY GOOD	YES
MUNICIPAL BONDS	YES	YES	NO	VERY GOOD	VERY GOOD	Excellent	NO
CERTIFICATE OF DEPOSIT	NO	NO	NO	Excellent	GOOD	GOOD	YES
MONEY MARKET	NO	NO	NO	VERY GOOD	Excellent	POOR	YES
TREASURY BONDS	NO	NO	NO	VERY GOOD	Excellent	Excellent	NO

Chairman **Rangel**. Mr. Horsman.

STATEMENT OF OLIVER W. HORSMAN, CLU, PRESIDENT, PRINCETON INFORMATION CORP.

Mr. **Horsman**. My name is Oliver Horsman, President of Princeton Information Corp. and editor of "Straight Talk," a monthly newsletter. I am a consumer advocate.

I would like to comment very briefly—and you have my full testimony in the record—on the issue of what the cash value of a life insurance policy really is.

We have heard a great deal of rhetoric from the industry, talking about the wonderful things that can be done with the magic of cash values. Gentlemen, here is a pitcher of water. The cash value of a life insurance policy, any cash value policy, is this part—the water. The cash value is a savings account. It is identical to a bank savings account. It is identical to a mutual fund. In a cash value policy you have term insurance from the top of the water to the top of the pitcher—term insurance—decreasing term insurance, if it is a level death benefit policy.

The only difference between a life insurance cash value and a bank savings account, is the fact that the life insurance cash value is tax-deferred. If it was sold as single-premium whole life, the agent would say that interest on the cash value is taxfree. Why should that be tax-deferred or taxfree when a bank savings account, which also provides education and mortgages and so on—or when a mutual fund which invests in the great American industry—is not tax-deferred?

It is a relevant point. This tax deferral is what makes single-premium whole life so terribly, terribly interesting to the people who have the money to invest in this kind of a product.

I would like to comment on that very briefly. We hear that people with $25,000, old people, have put their money in a single-premium policy. I would suggest that this does not prove that the policy is good; it proves that the sale was bad.

Incidentally, in case there's any question, I am a strong advocate of buy term and invest the difference.

The second point: single-premium whole life, in and of itself, is an inherently deceptive product. In the printed testimony, I mention three traps. At this moment I am going to mention only what the three traps have in common.

The first thing the three traps in a single-premium life insurance policy have in common is that the consumer is at the mercy of the life insurance company. Once a trap is sprung, the company can do almost anything it wants to the consumer and there is nothing the consumer can do about it.

The second thing these three traps have in common that the companies have baited all three with alluring promises that really aren't promises. Once the consumer realizes that these promises are not real promises, it is too late, and once again there is nothing he can do about it.

The third common characteristic of the three traps in single-premium whole life is that the teeth are the same. If the consumer cashes his policy in because he doesn't like the policy, or because it is not serving him properly any longer, every penny of the untaxed interest built up over the years is immediately reportable and taxable as ordinary income, every darned penny. The tax bill could easily be far greater than whatever he might have paid if he had reported interest every year as it was earned.

With that in mind and with the few minutes left, I would like to comment on the NALU "amount paid in test."

First, gentlemen, I would like to advise you that I have spent 30 years in the life insurance business. I am a CLU, whatever that is worth. I have become very cynical, so perhaps you will want to discount my conviction that any legislative proposal coming out of NALU will not significantly affect the selling of any product, including SPLI as an investment. I think the "amount paid in test" is a good example of how this works.

I am not a genius; my math skills are minimal; and I have a very old computer. But it took me about 30 seconds to catch the gimmick in the amount paid in test, and about 45 minutes working with this poor old computer to work out numbers. Take a good look at exhibit A and you will see what I am driving at.

Basically, using the NALU's own figures, which they may consider unrealistic—and if they correct my figures, I would appreciate a chance to comment on the corrections—the NALU proposal suggests a test where no premium can be greater than the premium for a five-pay life policy.

Incidentally, I doubt the industry has sold three of those in the last 20 years. Why they chose five-pay life is beyond me.

In any case, the five-pay life policy has a significant amount of life insurance in it. The cost of that life insurance in theory—that is the cost of this bit between the water in the pitcher and the top of the pitcher—that cost will discourage a policyowner from using the policy as an investment. I think this is nonsense, gentlemen.

After 5 years, all bets are off. The only limitation is the current single-premium limitation. So the policyowner can still reduce his death benefit, stay within the single-premium guidelines and still avoid thousands and thousands of income tax dollars. All you accomplish with the NALU amount paid in test is to spread the single-premium over 5 years. After 5 years everything is as abusive as it is today. The policyowner can still borrow on the policy without paying income tax. He can still create a guaranteed income stream, tax free, which is the next point I would like to refer to.

Why do people buy single-premium whole life? You heard a great deal of talk about the wonderful savings vehicle it is; it allows money to accumulate. May I suggest that if it allows money to accumulate, this is fine. I disagree with the way it is done, but if that is what the Congress wants, fine.

But SPLI is bought primarily in order to get the money out. It is bought with the end purpose of obtaining taxfree dollars. So my preference (as I recommend in the printed testimony) is to treat, as Mr. Stark's bill does, the withdrawals from a single-premium whole life policy or any single-premium policy as an annuity, and to tax them in the same way as an annuity is taxed.

Thank you, gentlemen.

[The statement of Mr. Horsman follows:]

UNITED STATES HOUSE OF REPRESENTATIVES

Subcommittee on Select Revenue Measures

Committee on Ways and Means

PUBLIC HEARING ON INVESTMENT USES OF LIFE INSURANCE

March 15, 1988

Testimony of:

Oliver W. Horsman, CLU
President
Princeton Information Corporation
Editor
STRAIGHT TALK Newsletter

Mr. Chairman, members of the Subcommittee on Select Revenue Measures, thank you for the opportunity to testify at this public hearing on "Investment Uses of Life Insurance."

Although the topic of his hearing has been published as "Investment Uses of Life Insurance", it appears the Committee's primary interest is SINGLE PREMIUM LIFE INSURANCE sold as an investment. So I will concentrate on the single premium life insurance problem, and save the broader problem (Investment Uses of Life Insurance in general) for a few comments at the end.

To save time, I'll refer to single premium life insurance as SPLI throughout this testimony.

There seem to be three questions:

1. Is it against the public interest to sell SPLI as an investment?
2. If so, why is it against the public interest?
3. What must be done to prevent SPLI from being sold as an investment?

IS IT AGAINST THE PUBLIC INTEREST TO SELL SPLI AS AN INVESTMENT?

The answer, I believe, is an unequivocal YES!

SPLI sold as an investment is bad for the economy in general, and for individual Consumers in particular. For both. SPLI sold as an investment can cause horrendous problems .. which I will describe in a moment.

But first, since I'm speaking for the record, it might be helpful to take a very quick look at just what SPLI IS.

As I'm sure representatives of the traditional industry have explained, SPLI is simply a large savings account with some term life insurance attached.

You can think of it as a glass of orange juice. The size of the glass is the total death benefit of the policy. The amount of juice in the glass is the savings account (or "cash value" as the industry calls it). And the empty part of the glass ... from the top of the juice to the top of the glass ... is the term insurance.

That term insurance, by the way, is paid for by money dipped out of the savings account. And, if you'll forgive me for using a technical term (it'll be the only one), the amount dipped out to pay for the term insurance is called the "mortality charge."

The savings account in SPLI is identical to a savings account in a bank, with only one significant difference. Interest earned in a bank savings account is taxed immediately, in the year it's earned. Interest earned in an SPLI savings account isn't taxed until it's withdrawn. And it's never taxed if the insured dies.

Woody Woodson, an undoubted industry leader, calls this savings account a "self-insurance fund", an interesting and completely accurate description."

The Treasury Department estimates that taxes lost on SPLI savings accounts cost America $1.8 billion dollars. This, I suggest, is peanuts, compared to what will be lost if strong and effective steps aren't taken to curb this tax abuse.

The industry has just been poking around the edges of SPLI as an investment. Of 2,000 or so life insurance companies in the United States, less than 200 are actively selling SPLI as an investment.

But, if Congress does not send a clear message to the industry that it will not tolerate this tax abuse, the entire industry will interpret Congress' lack of firm action as an endorsement. All 2,000 US companies ... plus 40 or 50 Canadian companies doing business in the US ... will launch aggressive SPLI investment sales campaigns as quickly as they can get policies approved and promotional literature off the press.

And when that happens, you'll see some of the most "creative" and aggressive selling in the history of the sales business. The $4½ BILLION in 1987 sales will increase 10-, 20-, 30-fold. And the loss of tax revenues is impossible to predict.

WHY IS SPLI SOLD AS AN INVESTMENT AGAINST THE PUBLIC INTEREST?

Huge losses in tax revenues due to SPLI sold as an investment would obviously hurt the economy. It's just as obvious that these losses would hurt the Consumer. But that's not the point I want to make in this part of my testimony.

Rather, I'd like to address problems faced by the individual Consumer who buys SPLI as an investment. In other words, is SPLI bought as an investment harmful to the Consumer?

The answer, I believe, is YES! Because SPLI sold as an investment is an inherently deceptive product. The Consumer is not given enough information to really understand what he's buying. And he certainly isn't warned about the three dangerous SPLI traps.

These traps, which I'll describe in a moment, all have three things in common.

First, all three put the Consumer at the mercy of the life insurance company. Once a trap is sprung, the company can do almost anything it wants to the Consumer ... and there's little or nothing the Consumer can do about it.

Second, the companies have intentionally baited all three traps with alluring "promises" that really aren't promises at all. Once the Consumer realizes that these "promises" are not real promises, it's too late. Once again, there's nothing he can do about it.

Third, the "teeth" of all three traps are the same. If the Consumer cashes his policy in, every penny of the untaxed interest built up over the years is immediately reportable, and taxable, as ordinary income! The tax bill could easily be far greater than whatever he might have paid if he had reported interest every year as earned!

These teeth make SPLI business especially desirable for a life insurance company. The company's grip on the Consumer was described just two months ago in Best's "Insurance Marketing Reports", a major industry marketing service. Referring to SPLI as it is currently being sold, the report asked, "After all, what could be more attractive to a life insurance company than a closed block of practically lapse-proof business?" [my emphasis]. "Lapse-proof" indeed, because the Consumer simply cannot get out!

A brief look at the SPLI traps will explain what I mean.

Trap One

The first trap is the INTEREST TRAP. It springs when the company reduces interest on the SPLI savings account ... for whatever reason.

Maybe the company can´t maintain the high rate that lured to Consumer to buy a "TAX-SMASHER" policy. Maybe that rate was artificial in the first place ... the kind of bait and switch gimmick that even industry leaders have complained about.

Or maybe company has decided this block of SPLI policies is now "ripe." They´ve been in force a while. The untaxed interest in them is substantial. Policyowners would loose a fortune in taxes if they cashed in. In other words, the block has become "practically lapse-proof."

So now the company can stop selling "TAX-SMASHER." It can close the block and reduce the interest it pays. And, with the interest it saves on the old block, it can pay a higher, more competitive rate on a new policy series ... "TAX-SMASHER II."

Sure, all companies would like to hold the interest line. All companies would like to treat old policyowners fairly. And many companies do.

But in the dog-eat-dog, gotta-increase-sales atmosphere of life insurance home offices, the "old" policyowner can be forgotten. The need to make today´s policies as competitive as possible ... the need to keep the field force happy ... can overwhelm any concern about current policyowners, especially those who are locked in anyhow.

Trap Two

The second trap is the COMPANY PRACTICES TRAP. It´s a little more subtle than the interest trap. To understand it, let´s take another look at the way SPLI is sold as an investment.

Many (perhaps most) companies use two gimmicks to help sell SPLI. One is "free" life insurance. The other is "no administrative charge."

There are two problems with these gimmicks. First, they´re untrue. Second, they can be dangerously misleading.

I´ll take untrue first.

The Consumer always pays for the term insurance part of an SPLI policy ... the part from the top of the juice to the top of the glass.

The Consumer also always pays his share of administrative expenses.

In most cash value policies (including some SPLI policies) the cost of the life insurance (the "mortality charge") is dipped out of the policy savings account. So are administrative charges.

But these charges are obvious and confusing. They get in the way during an SPLI sales pitch. And the "mortality charge" is embarrassing to agents trying to soft pedal the fact that SPLI is life insurance.

So some companies help the agent along. They hide mortality and administrative charges. Instead of dipping out of the savings account, these companies simply pay less interest to the policyowner.

In other words, where the company might "normally" have credited (for example) 9%, it now credits only 7½%, and uses the other 1½% to pay for "free" life insurance and administration.

The May 1986 issue of Changing Times, discussing mortality charges, put it clearly:

> "... you ´pay´ for the insurance by letting the company keep part of the money earned on the cash value [savings account part] of your policy."

So the Consumer really does pay for the term insurance part of his policy and for his share of administrative costs. If they aren´t dipped out of his savings account, they´re extracted from his interest.

As we see it, "free" life insurance and "no administrative charges" are strictly sales gimmicks. Their only purpose is to get the business on the books.

Do companies offering these gimmicks really intend to continue them after the policy has been in force a while? We doubt it! Because we have never seen an SPLI policy that guarantees these gimmicks for the life of the policy!

These gimmicks are only COMPANY PRACTICES. They can be withdrawn any time after the initial guarantee period (commonly three years).

In other words, the company reserves the right to dip into the Consumer´s savings account "sometime in the future" to pay for his term insurance and to cover administrative expenses.

When is this likely to happen? Probably when the block of business is "ripe" ... when that group of policyowners has accumulated so much untaxed interest that they don´t dare cash their policies in and face an impossible income tax bill.

But that´s not all. The company, you see, never has to tell a policyowner that it has started dipping into his savings account. There´s no legal requirement. So the company can simply DO it.

The much-touted SPLI annual statement (required by law) must, of course, reflect any dips into the policyowners savings account. But these "annual statements" are difficult to understand, at best. And some are totally incomprehensible. The policyowner may never know that he no longer has "free" life insurance and administration.

Even worse, the company can kid the policyowner along. It can brag about continuing to pay (in our example) 7½% interest and "holding the interest line." But, in fact, the policyowner´s real interest has dropped by the 1½% that is now being dipped out of his savings account.

In either case ... whether the policyowner realizes what is happening or not .. there nothing he can do about it. The COMPANY PRACTICES trap has sprung shut!

Trap Three

The last SPLI trap is the CHANGING LAW TRAP. Or maybe I should call it the GRANDFATHER TRAP.

Every company that sells SPLI knows that Congress will curb SPLI sold as an investment. It´s a given.

So the Consumer is assured that, if he acts now, his policy will be "grandfathered." Any new law limiting SPLI as an investment will not affect his contract.

This assurance, of course, is never put in writing by the company. And I´ve heard of only one agent who did so. But the assurance is there. Believe me. I´ve heard it time and time again from readers of my newsletter, STRAIGHT TALK. And, if necessary, I believe I can get all the confirmation you need from Consumers who actually bought SPLI as an investment.

Why is this assurance a "trap?" Just look at what happens if Congress puts retroactive curbs on SPLI sold as an investment. Existing SPLI policies will no longer be the great investments they were bought to be. In fact, as investments, they´ll be pretty poor.

But existing policyowners will be stuck with them, unless they want to pay accumulated income tax on their untaxed interest. So once again, the companies will keep the money, the agents will keep the commissions. And the Consumers will keep the policies, because they'll have no other choice. The GRANDFATHER TRAP holds its prey securely.

WHAT MUST BE DONE TO PREVENT SPLI FROM BEING SOLD AS AN INVESTMENT?

I hope I've satisfactorily answered the questions: "Is SPLI sold as an investment is "bad", and why is it "bad?" " I'd like now to move on to the third question: "What must be done to prevent SPLI from being sold as an investment?"

The best way to answer this question is to look at the sales feature of the policy that makes it so attractive.

Back in 1986, Personal Finance Magazine published an advertising supplement promoting SPLI as an investment. Though that supplement is over two years old, it's as forceful a pitch for SPLI as you're likely to find. And its message very much up to date.

The supplement lists four reasons why SPLI is a great investment.

1. Accumulate and build up wealth TAX-FREE;
2. Create a guaranteed income stream TAX-FREE;
3. Protect your estate and your family TAX-FREE;
4. Make a high-yield investment that is virtually RISK-FREE.

All four reasons have some bearing on the sale. But far and away the most important are reasons 1 and 2.

Let's take them one at a time.

"Accumulate and build up wealth TAX-FREE"

The "wealth" they're talking about here is personal wealth for the policyowner. We are not talking about wealth for his family or his estate. We're talking about wealth the policyowner will use while he's alive.

If there's any question about this, just note pitch three: "Protect your estate and your family TAX-FREE." It ranks third in importance. And, more importantly, it's an entirely separate thought from "accumulate wealth" and "create a guaranteed income stream."

If the policyowner were really interested in protecting his "estate and family", he'd buy large amounts of term insurance ... or, at worst, whole life. But instead, he's being pitched to buy SPLI, the lowest death benefit policy available.

Is "accumulating wealth TAX-FREE" really the policyowner's prime objective? Perhaps, for some folks. But for the man or woman who buys SPLI as an investment, the only reason to "accumulate wealth TAX-FREE" is to ...

Create a guaranteed income stream TAX-FREE!

By borrowing on his SPLI policy, INTEREST-free, he can create a stream of income that will last the rest of his life. And every penny of that income will be TAX-FREE!

The industry contends that SPLI is not bought to "create a guaranteed income stream TAX-FREE." To prove this contention, they claim that only 5% of total SPLI deposits have been borrowed.

While the statistic may be correct, using it to support the industry's contention is absurd. Of course only 5% has been borrowed ... so far! But just see how tax-free borrowing explodes in a few years, after policyholders have had time to "accumulate and build up enough wealth TAX-FREE!"

So the number one attraction of SPLI sold as an investment is "**A GUARANTEED INCOME STREAM TAX-FREE.**" It is the **GUARANTEED INCOME STREAM** that must be attacked if SPLI sold as an investment is to be squelched.

How is this done? By recognizing that SPLI sold as an investment is not life insurance at all. It's an annuity, with a bit of life insurance thrown in to make it a legal tax dodge!

So, if SPLI sold as an investment **is** an annuity, it should be taxed as an annuity. And by taxing it as an annuity, SPLI sold as an investment will **dry up and go away!**

Here's how annuity taxation works. There are two stages in the life of an annuity, the "accumulation" stage and the "life income" stage. For purposes of this testimony, we can ignore the "life income" stage.

During the accumulation stage, the annuity is nothing more than a savings account. Interest on this annuity savings account (cash value) is allowed to accumulate untaxed. In this respect, it's identical to SPLI or any cash value policy.

Abuse is prevented by controlling withdrawals from the annuity, including loans from the insurance company or from a bank (using the policy as collateral). Any withdrawals or loans are considered interest until all interest is withdrawn. That interest is taxed immediately. Income tax must be paid in the year of the withdrawal or loan.

And to make the intent of Congress even clearer, a additional 10% penalty tax must be paid if the withdrawal or loan is made before the policyowner reaches age 59½!

Current annuity taxation was legislated for exactly the same reason Congress is now tackling SPLI. Annuities were being sold exactly as single premium life insurance is being sold today ... as an investment which allowed the investor to ...

1. Accumulate and build up wealth TAX-FREE; and ...
2. Create a guaranteed income stream TAX-FREE.

To summarize this point: single premium life insurance is really an annuity with incidental life insurance thrown in. Single premium life insurance is abusing the tax code just as annuities once did. So why shouldn't single premium life insurance be taxed as an annuity?

Perhaps the following legislation would be effective.

POINT ONE: Define SPLI as an annuity, subject to existing annuity taxation rules.

Since these rules are already in place, Congress would avoid the time-consuming, complicated and (sometimes) inexact task of drafting detailed legislation dealing with a complex five-premium or seven-premium or whatever-premium test.

POINT TWO: Make the legislation effective January 1, 1986.

This would catch most policies sold as abusive tax-shelters, and would send an important message to the life insurance business:

> "If you challenge the will of Congress, you won't get away with it!"

POINT THREE: Protect current SPLI policyowners by (1) requiring companies to provide refunds, plus interest and without surrender penalties, to policyowners who so request; (2) allowing SPLI policyowners to spread any tax liability over three or four years and (3) requiring companies to provide a detailed explanation of SPLI taxation to all SPLI policyowners.

SPLI policyowners who wish to keep their policies would, of course, be allowed to do so. Their interest would continue to accumulate untaxed; their death benefits would not be affected;

and, if they chose, they could annuitize their policies (take lifetime income) under existing annuity rules. However, they could not **"create a guaranteed income stream TAX-FREE."**

Would Point Three work a hardship on life insurance companies that have sold SPLI as an investment? Quite possibly. But the hardship would not be an unfair hardship. After all, those companies reaped a bonanza by ignoring the wishes of Congress. Doesn´t it seem reasonable they should refund part of that bonanza to the policyowners?

POINT FOUR: Instruct the IRS to require detailed reports from any life insurance company that is engaged in what the IRS suspects is a tax-abusive sales practice. Summaries of such reports would be submitted to Congress annually or at a Committee´s request.

The IRS, as I understand it, may require reporting from any entity if the IRS suspects the tax code is being abused. Point Four requires the IRS to obtain such reports when the entity is a life insurance company.

The "Legitimate" Buyer of SPLI

Would this legislation hurt Consumers who bought SPLI for "legitimate" reasons? The answer to this question depends on how you define a "legitimate reason."

The only significant "legitimate" reason I know of is an estate and income tax avoidance scheme used by wealthy parents and grandparents.

The wealthy individual buys an SPLI policy on a child´s life and gives the policy to the child. The parent or grandparent (donor) can escape both gift and estate taxes on the single-premium gift. The donor and child escape income tax on the interest earned by the policy savings account (cash value). And later, the child can borrow money from the policy income tax free.

Generally, the selling agent emphasizes the income tax free loan, perhaps for the laudable purpose of going to college or buying a home. I applaud such purposes. But I question whether this tax break for the wealthy works to the benefit of the great masses of middle-income, middle Americans.

THE NALU "AMOUNT PAID IN TEST"

I would like to take a moment now to comment on the "amount paid in test" proposed by the National Association of Life Underwriters.

First, let me point out that NALU represents a major part of those who make their living selling traditional life insurance policies ... including SPLI. Perhaps I´ve become a little cynical after nearly thirty years in the business. So perhaps you will want to discount my conviction that any legislative proposal coming out of the NALU will not significantly affect the selling of any product ... including SPLI as an investment.

The "amount paid in test" is, I believe, a superb example of why I´m so cynical.

I´m certainly no genius. And my math skills are minimal. But it took me only 30 seconds to catch the gimmick in the "amount paid in test" ... and another 45 minutes, working with a primitive computer, to do the calculations that demonstrate the gimmick. These figures are attached as Exhibit A.
I used the NALU´s own figures: 10% interest and five $4,987 premiums for a $100,000 five-pay life policy issued at age 30. I´ve also assumed that the company doesn´t pay 10% to the policyowner. Rather, it pays only 9% ... and uses the 1% difference to help pay mortality and administrative charges.

If these assumptions seem unrealistic to NALU, I´m sure they´ll "correct" my figures. I would, of course, appreciate a chance to comment on their "corrections."

The NALU proposal suggests a test where no premium can be greater than the premium for a five-pay life policy. According to NALU, the five-pay life policy has a "significant" amount of life insurance in it ... and the cost of that life insurance (the amount dipped out of the orange juice) will (according to NALU) discourage a policyowner from using the policy as an investment.

Nonsense!

After five years, all bets are off. The only limitation is the current single-premium limitation. So the policyowner can reduce his death benefit, stay within the single-premium guidelines, and still avoid thousands and thousands of dollars in income tax.

All you accomplish with the NALU "amount paid in test" is to spread the "single premium" over five years. After five years, everything is as abusive as today. The policyowner can still borrow on the policy without paying income tax. He still can "create a guaranteed income stream TAX-FREE!"

Here are some numbers from Exhibit A. We show five premiums of $4,987 each. That's a total of $24,935. At age 60, the policyowner will have $280,837 of untaxed interest in his savings account ($305,772 minus $24,935).

If we assume the 9% interest rate continues, he'll be able to borrow something between $25,000 and $30,000 per year for the rest of his life and never pay a nickel's worth of income tax on any of it!

So ... is the five-pay policy any less attractive than single premium? Is it any less salable? Is it any less abusive? I don't think so.

A couple of more points on the NALU proposal.

First, it attacks the wrong thing. This, of course, doesn't surprise me. By using an "amount paid in test", it allows the extraordinarily creative members of NALU to come up with any number of premium gimmicks that you and I can't even contemplate.

Second, I believe there is ample precedent to question anything the traditional industry says ... to doubt the traditional industry's sincerity. Here are two examples.

When the first Treasury tax reform proposal was published, the traditional life insurance business became hysterical. The result was a massive "grassroots campaign" designed to terrify the American public, and to take the teeth out of Treasury's life insurance proposals.

We described that campaign in the May, 1985, issue of STRAIGHT TALK. We titled it: **"LIFE, DAMNED LIES AND STATISTICS."**

Rather than rehash the entire issue, I'll quote just one statement that I consider grossly misleading: "The government would tax the increase in the value of individual life insurance policies." We hear the same nonsense today when the industry rages against proposals to "tax the inside build up."

The impression given ... and I believe it is intentional ... is that Congress want to tax the entire "inside build up", including the part that is attributable to annual deposits into the life insurance savings account.

The fact is this. Neither Treasury, nor Congress, nor anyone I know has ever suggested such a tax. No one! The only thing ever proposed has been to tax interest paid on a life insurance savings account the same way we tax interest paid on a bank savings account.

No one has ever proposed tax the part of cash value growth that comes from annual deposits into the life insurance savings account.

I am absolutely convinced that the perpetrators of the "grassroots campaign" knew then and know now that the cry, "Don't let them tax the inside build up!" is a gross exaggeration. In my book, an intentional exaggeration purposely designed to mislead the public is a damned lie!

Perhaps this is a measure of just how much faith you can put in industry statements and the statements of organizations supporting the industry.

The second example of a reason to doubt the industry's sincerity bears an eerie resemblance to the current SPLI problem. I'm referring to the so-called "four out of seven rule" for minimum deposit life insurance sales.

"Minimum deposit" was a scheme to convert cash value life insurance to term ... and still pay cash value commissions which generally are five to ten times greater than term commissions.

The idea was reasonably simple. The policyowner paid premiums on his whole life policy by borrowing (tax-free) on the policy cash value. As a result, he enjoyed tax-free (actually tax-deferred) interest on his policy savings account (cash value), and was able to deduct the interest he paid on the accumulated loans.

He was also locked into the program for exactly the same reason that the SPLI policyowner is locked into his SPLI policy.

Congress objected to a "pattern of borrowing" that allowed the taxpayer to deduct interest paid on money borrowed from a tax-deferred savings account. There was talk about taxing life insurance loans as ordinary income.

This, the industry objected to. "Typical" policyowners, it was argued, would be denied the right to borrow on their policies for emergencies, etc.

So a "compromise" was reached. Congress enacted the "four of seven rule" which said, in effect, if the policyowner paid four of the first seven premiums in full, he was deemed not to have bought the policy with a "pattern of borrowing" in mind.

But this "compromise" was not a compromise. It was a glorious victory for the life insurance business and for minimum-deposit. Sales weren't hurt in the least.

In fact, the "four of seven" rule actually improved sales ... because it appeared that Congress had given its stamp of approval to this tax-abuse scheme.

I'm afraid the same sort of thing will happen if Congress enacts any SPLI "amount paid-in test." The industry will claim that Congress endorses SPLI sold as an investment. NALU will brag that its "test" somehow makes SPLI sold as an investment "moral" and "okay." And, as mentioned before, you will see wildly "creative" sales gimmicks to back up these claims.

The result will be an explosion of SPLI investment sales such as you and I can't possibly imagine ... just as minimum-deposit sales exploded after Congress attempted to restrict them.

Incidentally, minimum-deposit for Consumers is dead today. But it wasn't killed by the 1962 "four of seven rule." Its execution took place in 1986, when Congress ripped the heart out of minimum deposit by restricting the deductibility of Consumer loan interest.

I realize that stomping out minimum-deposit wasn't the reason Congress restricted loan interest. But minimum deposit is just as dead, which proves you can end a tax-abuse scheme if you stab in a fatal spot.

"A guaranteed income stream TAX-FREE" is the heart of SPLI sold as an investment. It's there, I suggest, that the legislative dagger should be plunged!

THE BROADER PROBLEM

Earlier I mentioned a broader problem, one that has to be solved if we want to eliminate future life insurance tax gimmicks.

That broader problem is tax-deferred interest on life insurance savings accounts (cash values). As long as interest is tax-sheltered inside a cash value policy, there will be industry hotshots finding abusive tax gimmicks that capitalize on the fact.

A life insurance savings account is virtually identical to a bank savings account ... except ... interest on a life insurance savings account is tax-deferred.

The industry defends this unjustified competitive advantage by piously spouting a mass of wild fantasies. The wildest and most popular is the "permanent" fantasy. According to this fantasy, tax-deferred interest in necessary to promote the sale of so-called "permanent" life insurance.

And why is "permanent" life insurance so important? To fill so-called "permanent" needs, of course.

There's just one problem with these "permanent" arguments. There is no such thing as "permanent" life insurance; and there is no such thing as a "permanent" need. Both are self-serving figments of the industry's fertile imagination!

The only "permanent" need any of us has is a permanent need for CASH. When we're young and have families ... and very little cash ... life insurance is perfect as a substitute for cash. But when we retire, life insurance is useless. When we retire, there is no substitute for cash.

So life insurance is a temporary substitute. Something to be bought as cheaply as possible and disposed of as soon as possible. The man or woman who plans to need life insurance at retirement, is planning to be a financial failure.

High-premium, high-commission "permanent" life insurance is just as fanciful. I've shown you what cash value ("permanent") life insurance really is, a combination of a tax-deferred savings account and term insurance. As the savings account increases, the term insurance decreases.

Woody Woodson calls the savings account a "self-insurance fund." So if you take the "self-insurance fund" out of the equation, what kind of real insurance do you have left? Decreasing term! And there's no possible way decreasing term could ever be considered "permanent" insurance!

The industry also claims that cash value life insurance "forces the Consumer to save" through the "gentle compulsion of a premium notice." This is more hooey. The financial jellyfish who has to be tricked into saving by buying cash value life insurance, is the same guy who will borrow his entire cash value as soon as he has any, and then lapse his policy because he can't afford to pay both premiums and interest.

Yes, Americans have one of the lowest savings rates of all industrialized countries. And our massive life insurance industry hasn't been much help.

Perhaps it's time to take away the life insurance tax advantage and return it to the Consumer ... in the form of fewer restrictions and higher limits on individual retirement accounts!

There are a thousand other fantasies the industry will throw at you to support their competitive tax edge. We don't have time to cover them all here.

But one thing is clear. Cash value life insurance must have special tax advantages to survive. Without the Federal subsidy represented by special tax breaks, cash value life insurance would disappear from the market place.

So I'd like to ask you one parting question: In these days of huge budget deficits, is it really in the public interest to provide tax subsidies for an industry that demonstrates its contempt for Congress and the Consumer by abusing those subsidies.

Thank you for allowing me to express my opinions on "investment uses of life insurance."

EXHIBIT A

Assumes That The Company COULD Pay 10% To The Policyowner ...

But Actually Pays 9%, and Keeps 1% for "Free" Insurance & Administration

Age	Premiums Paid	Year End Cash Value	Corridor*	Death Benefit	Term Insurance	Percent of Term**
30	4987.00	5435	40.0	100000	94564	0.94
31	4987.00	11360	40.0	100000	88639	0.88
32	4987.00	17819	40.0	100000	82180	0.82
33	4987.00	24858	40.0	100000	75141	0.75
34	4987.00	32531	40.0	100000	67468	0.67
35		35459	40.0	88649	53189	0.60
36		38651	40.0	96627	57976	0.60
37		42129	40.0	105324	63194	0.60
38		45921	40.0	114803	68882	0.60
39		50054	40.0	125135	75081	0.60
40		54559	40.0	136398	81838	0.60
41		59469	41.1	144694	85225	0.58
42		64821	42.4	152881	88059	0.57
43		70655	43.7	161683	91027	0.56
44		77014	45.0	171143	94129	0.54
45		83946	46.5	180529	96583	0.53
46		91501	47.8	191425	99923	0.52
47		99736	49.3	202304	102568	0.50
48		108712	50.8	214001	105288	0.49
49		118496	52.3	226571	108074	0.47
50		129161	54.1	238745	109584	0.45
51		140786	56.2	250508	109722	0.43
52		153456	58.5	262319	108862	0.41
53		167267	61.0	274209	106941	0.39
54		182321	63.7	286219	103897	0.36
55		198730	66.7	297947	99216	0.33
56		216616	68.5	316228	99612	0.31
57		236112	70.4	335386	99274	0.29
58		257362	72.5	354982	97620	0.27
59		280524	74.6	376038	95513	0.25
60		305772	76.9	397623	91850	0.23
61		333291	78.1	426749	93458	0.21
62		363287	79.4	457541	94253	0.20
63		395983	80.6	491295	95311	0.19
64		431622	82.0	526368	94746	0.18
65		470468	83.3	564787	94319	0.16
66		512810	84.0	610198	97387	0.15
67		558963	84.7	659310	100347	0.15
68		609270	85.5	712430	103159	0.14
69		664104	86.2	769887	105782	0.13
70		723873	87.0	832039	108165	0.13
71		789022	88.6	890142	101120	0.11
72		860034	90.2	952630	92595	0.09
73		937437	91.9	1019840	82403	0.08
74		1021807	93.5	1092141	70333	0.06
75		1113769	95.2	1169926	56156	0.04

* The "Corridor" is the maximum cash value per $1,000 of death benefit permitted under present law.

** This is the ratio between TERM INSURANCE and total DEATH BENEFIT. It is the percent of REAL risk the company bears. So, at age 60, for example, only 21% of the death benefit is insurance (or "risk"). The remaining 79% is the "self-insurance fund" (i.e. "cash value" or "savings account"). It is interesting to note that the technical name for the term insurance inside a cash value policy is "NET AMOUNT AT RISK."

Chairman RANGEL. Thank you, Mr. Horsman.

Mr. Regan, how would you respond to Mr. Horsman's analogy to the savings bank account, as well as the incentive to withdraw the money rather than to allow it to accumulate?

Mr. JOHN REGAN. First of all, that is a two-part question.

As to the second part of it, the incentive to be able to access funds is an important part of the sales process. Consumers do not want to feel that they are parting from their dollars in perpetuity. They want to feel they have access to the funds.

Chairman RANGEL. We know of the sales advantage. I am talking about the savings advantage, where it is in our national interest to beat the Japanese and Germans.

Mr. JOHN REGAN. I think that anything we can do that encourages the growth of long-term savings in this country is good for the country.

The difference between the savings account in a bank and an insurance company is that ordinarily the consumer will go to the bank and commit for a 2-year CD or a 4-year CD, whereas when they give it to the insurance company, the insurance company gives them liquidity rights. They know statistically they are very seldom exercised. The insurance company, in turn, takes what might be in the consumer's mind short- or medium-term money and invests it long.

That is an important difference between the insurance company and the bank.

Chairman RANGEL. Are you sure you don't want to add to that? I mean, that is it? In terms of savings and penalties for withdrawal, you think that that separation is sufficient?

Mr. JOHN REGAN. I think that that is an important separation insofar as getting long-term moneys into the economy.

I think that there are an awful lot of additional features that the single-premium product has that the bank doesn't have, that have been discussed here today: protection for the family, et cetera.

Chairman RANGEL. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

I suspect, Mr. Horsman, that your position against single-premium policies is that of equity. You feel that as between this product versus all of the other investment instruments, why should this product get any favored treatment.

Mr. HORSMAN. That is correct, sir.

Mr. MCGRATH. I think these hearings have been constructive, and I think the committee will have ample testimony and facts now to go back and do its job.

Thank you.

Chairman RANGEL. I thank the gentleman from New York, and I want to thank this panel and all of the witnesses for bringing their professional opinions to us. Don't be surprised if we won't be coming back to you for additional information as we move along.

The hearing stands adjourned.

[Whereupon, at 2:25 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

atac
American Travelers Assurance Company
820 Keo Way / Des Moines, Iowa 50309 / Phone 515/283-0285

Written testimony submitted to the hearing on investment uses of Life Insurance

Robert Leonard
1102 Longworth Building
Washington, DC 20515

Dear Committee Members:

The following are my thoughts on several issues relating to your proceedings:

Historical Perspective

In the late 1970's and early 1980's, the Federal Trade Commission made a scathing attack on the insurance industry because the rate of return to the consumer was not up to the commission's standards. Even though the FTC was using a very unfair and outdated system to measure rate of return, the insurance industry listened and reacted by providing products that were much more consumer oriented from the investment aspect (i.e. Universal Life). These new products are very popular with the consumers. They not only can buy a very flexible life insurance policy, but they can receive a fair rate of return on the build-up of cash value in the policies.

Organizations (people who are so inflexible and believe that everyone should buy term insurance) have been attacking the new products through a few congressmen. These attacks are very self-serving and unfounded. I would hope this committee would be more flexible in their approach to the issue than Representative Stark, Representative Gradison, and the A.L. William's people. To be flexible is to realize that not all people seeking protection should buy universal life or any permanent insurance. Not all people should buy single premium life insurance. Not all people should buy term insurance. Each product has its own place. I personally own a large term policy and a large universal life policy. One is for temporary protection (term). The universal life is for permanent long term protection. I feel that Representative Stark and Representative Gradison are trying to legislate the type of insurance people should be buying and that is wrong!

The Problem Today

Some companies sell products that can be abusive. One such product is single premium whole life. The other product is single premium variable life. What makes the products abusive is not that people pay a single premium, the products are abusive for two reasons:

1. The insured is not charged any mortality costs for the net amount at risk.
2. The net amount at risk is very small because the companies use a very high guaranteed mortality table to set the death benefit in relation to the premium.

Very simply, that is the problem. Those products have gone to the extreme from an investment standpoint.

Solution

Because the problem is fairly simple, the solution is also quite uncomplicated:

1. As of May 1, 1988, in order for any life insurance contract to qualify under the present rules of life insurance taxation, a mortality charge for the net amount at risk must be paid by the policyowner or insured.
2. Those companies who sold life insurance products and did not charge for the cost of mortality, must allow those policyowners a surrender option without penalty, or they must allow a policyowner to convert to an annuity without penalty.

Summary

I firmly believe the above two solutions would solve the problem of using life insurance products for investment purposes only. I have attached several other possible solutions and facts about the type of people purchasing single premium products. As you can see, they are not "fat cats" trying to abuse the system, but people trying to purchase products to help them meet future needs.

Sincerely,

Richard E. Hamilton

Richard E. Hamilton, CLU
Vice President Marketing

SINGLE PREMIUM LIFE INSURANCE FACTS AND SUGGESTED CHANGES

1. Ten billion dollars were paid into Single Premium Life Insurance policies in 1987. 250 billion was invested in money market funds, and 500 billion in C.D.'s. More than 200 billion dollars of new mutual funds were purchased in the same year.

2. The mean age of the customer purchasing a single premium life insurance policy is 62 years old. There are an equal number of males and females.

3. Nearly half the policyowners are retired. 37% are employed or self-employed. 12% are homemakers, and 2.5% or unemployed.

4. 32% of the policyholders had taxable income of less than $25,000. 60% of the policyholders have taxable income of less than $60,000.

5. 70% of total single premium sales are to people 50 years old or older.

6. 68% of the single premium sales are for less than $25,000.

7. 7.4% of the policies have loans equal to 3% of the total value of these policies.

8. Reasons for buying single premium life:

    A. Long term care costs
    B. Increase size of estate
    C. Adequate care for surviving spouse
    D. Pass directly to heirs, no probate

9. Suggestions to stop abuses of Single Premium Life:

    A. Limit single premium purchases to $100,000 of premium per insured.
    B. Require all companies to use the same set of assumption when fixing death benefit in relationship to premiums.
    C. Use 6% interest assumptions.
    D. Use a 1980 CSO mortality assumption.
    E. Require all companies to charge mortality costs on the risk factors above.
    F. Before age 59 1/2, allow tax free access for health care costs, educational costs, and primary residence purchases.
    G. After age 59 1/2, allow access for any purpose.

Ernst & Whinney

1225 Connecticut Ave., N.W.
Washington, D.C. 20036

202/862-6000

March 11, 1988

The Honorable Hank Brown
United States House
of Representatives
1424 Longworth Building
Washington, DC 20515

Dear Congressman Brown:

You have inquired about the ramifications of potential retroactive changes (i.e. the lack of full grandfather provisions) relating to the taxation of existing life insurance contracts .

Life insurance premiums are based on numerous assumptions as to the future, including mortality, investment yield, expenses and persistency. These estimates of future experience are naturally predicated on facts at the date premiums are set, including tax laws.

It is inherent in the economics of life insurance that a life insurance company incurs significant investment in the early years of a policy's life because sales costs, policy set-up, underwriting and other expenses are greater than initial premiums received. This investment by the insurance company can only be recovered if a policy persists (e.g. the policyowner keeps the policy and pays premiums long enough for the initial costs to be recovered). For certain extremely competitively priced products, the investment recovery period can be as much as ten years or more. This means that if a policy terminates prior to that time, the insurance company's initial investment in the policy is never recovered and no profits (and related income taxes on those profits) will emerge later. Since tax laws in effect when a policy is sold are an important consideration to both the life insurance company in pricing its product and to the consumer who is buying the product, any significant tax law change that affects existing policies will almost certainly adversely affect the persistency of a policy. Further, a life insurance contract is long-term and unilateral; the company guarantees premium rates to the consumer but the consumer can stop paying premiums at any time and effectively terminate the contract.

Therefore, it would appear to me that the failure to fully "grandfather" existing policies in any tax legislation would unfairly cause the life insurance industry significant economic losses by hastening termination of policies by consumers which, in turn, would not allow recovery of expenses already incurred by insurance companies. The consumer also suffers from early lapsation. In addition, anything short of full "grandfather" provisions for existing policies would create a significant administrative burden on both insurance companies and the consumer. Based on the foregoing, I believe fairness would dictate that any tax law changes be prospective only, to allow the industry recovery of past "sunk" costs.

Although it would be difficult to quantify, I would also suspect that future tax revenues from the insurance industry could be significantly reduced as adverse persistency would reduce future profits on which the industry will pay taxes.

I would encourage a thorough review of these and other aspects of insurance contracts to ascertain that equity, for both the insurance industry and the consumer, is achieved in any tax legislation.

Very truly yours,

Robert E. Foss

Robert E. Foss
Partner

REF:cjd

STATEMENT OF
JOHN HANCOCK MUTUAL LIFE INSURANCE COMPANY
BOSTON, MASSACHUSETTS
TO
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS

This written statement is submitted by the John Hancock Mutual Life Insurance Company (the "Hancock") of Boston, Massachusetts. It is requested that it be added to the printed record of the public hearing on the investment uses of life insurance held by the Subcommittee on March 15, 1988.

The Hancock is one of the largest and oldest (1862) life insurance companies in the United States. Major product lines of the Hancock and its subsidiary, John Hancock Variable Life Insurance Company, are permanent life insurance and annuities. By far the most significant segment of its life insurance sales are to middle income taxpayers. In general this encompasses households with annual incomes of between $20,000 and $50,000. In 1987 approximately 60% of all life insurance premium received by the Hancock life insurance companies was for variable life insurance. Last year over 95% of our variable life insurance policies were other than single premium policies with an average annual premium of only $860. John Hancock Variable Life Insurance Company was one of the first to sell variable life when it was introduced in the early 1980s, and is one of the major carriers in that market.

As stated in Press Release #9 (February 18, 1988), the purpose of the Subcommittee's hearing was:

> to analyze the current use of life insurance policies, particularly single premium policies, and other policies marketed primarily as investment vehicles, and to consider whether the present law tax treatment of life insurance is appropriate in light of these uses.

The Hancock is in general agreement with the prepared testimony presented at the hearing by Mr. Schweiker for the American Council of Life Insurance (ACLI). Over at least the last six years Congress has conducted an extensive and thorough review of the income tax treatment of life insurance contracts including single premium contracts. And as recently as the Tax Reform Act of 1986 Congress generally reaffirmed the tax rules for life insurance contracts. In particular, we agree, as stated by ACLI, that the Stark/Gradison H.R. 3441 distributional approach covering all permanent life insurance policies and the NALU definitional approach denying life insurance status for certain policies go too far. Should the Subcommittee nevertheless determine to change the taxation of single premium life insurance policies, we will support ACLI efforts to explore whether a reasonable combination of these approaches on a much narrower basis can be developed.

However, the Hancock is concerned after reviewing the prepared statements of those who testified at the hearing that certain proposals in the statements went far beyond the scope of the hearing's purpose. For example, in the last full paragraph on page 7 of his statement, Professor Andrew Pike of American University Law School suggests cutting back the existing definition of life insurance for all life insurance contracts and that:

> One possibility would be to allow interest credited under a life insurance contract to be excluded from gross income only to the extent that it is applied to pay for the costs of term insurance actually provided. Any additional interest credited would be taxed currently to the owner of the life insurance contract.

This is a startling and one of many excessive proposals made at the hearing in the context of the narrow debate over recent single premium life insurance sales.

A specific concern of John Hancock relates to certain possibilities on the future treatment of variable life in Treasury's written testimony and the Joint Committee staff pamphlet. Variable life insurance is fundamentally no different than other life insurance and thus its tax treatment must be the same.

As recently as the 1984 Deficit Reduction Act, Congress, after study of variable life contract functions, expressly included variable life insurance in both the definition of life insurance and the life insurance company tax provisions. Now to reject both such treatments by fiat, as would occur under the possibilities raised by Treasury and the Joint Committee staff, cannot be reconciled with the thoughtful actions on the same subjects taken so recently. All policyholder tax effects for variable and other life insurance contracts, are based squarely on the well-established tax principles of constructive receipt and realization of income; to deny application of these basic tax rules to variable life would be totally baseless.

The Subcommittee is to be congratulated on its open-minded approach to this matter, and the Hancock supports a fair resolution of the objectives of the hearing. However, if the Subcommittee determines that corrective action is necessary, it is imperative that any action be limited to correcting the perceived abuse. Current law should be retained for other life insurance policies.

Respectfully submitted,

Raeburn B. Hathaway Jr.

Raeburn B. Hathaway, Jr.
Senior Vice President & Secretary
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STATEMENT OF PROF. RICHARD S. LEVITZ, UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

The Tax Reform Act of 1986 (TRA) was very kind to the insurance industry. While clamping down on many tax favored investments (shelters), it essentially left the insurance industry unscathed. With an intensive lobbying effort the industry managed to retain favorable tax treatment overall. As a result, more and more Americans have turned to life insurance products as a vehicle for investment. More specifically, single premium whole life insurance has been the focus of these new "investors." According to Congressman Pete Stark (D-Cal.) sales of single premium life insurance policies have increased from $1.5 billion in 1985 to an estimated figure of $10 billion in 1987.[1] This represents an increase of over 600%, in a two-year period. Stark is concerned that single premium life insurance has become an abusive tax shelter virtually overnight. What is it that has made single premium Life Insurance such an attractive purchase, or should we say, such an attractive "investment"?

To begin with, it is crucial to understand what single premium life insurance is and how it differs from other basic life insurance policies. One such policy is term life insurance. This type of policy protects the insurer for only a limited time. The death benefit (proceeds from the death of the insured) is payable only if death occurs during the term of the contract, while nothing will be paid should the insured die after the stated term. Upon expiration of a term, a new policy will have to be taken out for further insurance. The premium paid is strictly for death benefits and not for any investment purposes. In other words, there is essentially no cash value for these policies. It is strictly an insurance vehicle. The premium charged for term insurance is directly related to the insured's risk of death in that term. The premium will increase with each new term as the risk of death increases with age. The advantage of term insurance is that premiums will generally start low, so young adults can purchase large amounts of insurance despite a rather moderate income.[2]

In contrast to term insurance, whole life insurance policies include level payments of premium throughout the life of a single policy, as opposed to the separate series of payments made with term insurance. Thus, one policy will cover the entire life of the insured. Unlike term insurance, this type of policy does have an investment element. This is best explained by analyzing the makeup of a life insurance premium payment.

Essentially there are three elements.[3] First is the mortality expense, or more commonly, the cost of insurance. This is determined by actuaries and is a very complex matter. The cost of mortality is basically determined by looking at the insured's general health, and the rate at which others similarly situated are dying. Thus, the cost of mortality could increase or decrease over time. However, it is safe to say that generally, assuming no health problems, the cost of mortality increases steadily with age. In a whole life policy, because premiums are level throughout the lifetime of the policy, the insured generally overpays his cost of mortality in the early years of the contract. The second element of premium is loading costs. This is the portion of the premium designed to cover the insurance company's expenses, such as agent's commissions, processing costs, and other various fees. The final component of premium is the investment component. The investment component is the premium payment remaining after mortality costs and loading fees have been accounted for.

The investment component is commonly referred to as the "cash value" of the policy. The cash value is generally invested by the insurance company for the insured at a fairly competitive rate. Insurance companies tend to invest this money in some type of a mutual fund. The earnings from the invested money are referred to as inside buildup. The inside buildup is tax favored, as it grows tax deferred. In other words, the insured does not have constructive receipt of the investment earnings and therefore is not taxed until he has actual control of the earnings. This, unlike a certificate of deposit or savings account, allows an insured to deposit money, earn income and yet pay no taxes on the money. Although the insured could reach these earnings through withdrawals and loans, whole life insurance is generally not viewed as an investment. Rather, a person who purchases a whole life policy is viewed as purchasing insurance first and investment opportunities second. The level premium payment illustrates this. For example, a young adult in good health will have a low cost of mortality in the early years of the policy, and therefore in a few years will have a substantial investment component. However, in later life, the cost of mortality will be far greater and will exceed the annual premium payment. Thus, the increasing cash value is needed to cover these costs, and is not viewed by the insured as key source of income.

Although tax-free dollars will be used to pay for this additional cost of mortality, the Internal Revenue Code does not view this as an investment. Rather, it is viewed as a method of encouraging Americans to provide financial protection for their dependents upon the insured's death. In other words, the main focus of the insured is to provide life insurance protection to his heirs, and not to earn investment income. Although policy loans and withdrawals can be taken, whole life policies are not an abusive investment.

Unlike traditional whole life, however, single premium whole life insurance is generally viewed in the market as an investment first, and life insurance second. In general, single premium policies have just enough of an insurance element to qualify as life insurance under Section 7702 of the internal revenue code. Life insurance is tax favored under the internal revenue code, and includes such benefits as: the exclusion of death benefits from the gross income of beneficiaries; tax deferral of inside buildup, generally tax-free withdrawals, and tax free loans which essentially act like a withdrawal. Thus, single premium policies are sold recognizing that they must have enough of the insurance component to meet the 7702 definition, thereby enjoying the favorable tax treatment. Well, the next question is, what exactly is single premium life insurance?

A single premium insurance policy is one in which a lump sum is deposited, generally above a $5,000 minimum floor, in return for a paid-up insurance policy. Thus, it is a whole life policy in which only one premium payment need ever be paid. The death benefit will vary depending upon the size of the deposit, the age of the insured, and the health of the insured. Dollar for dollar, single premium insurance generally is not the most effective way to purchase insurance, as the insured will only receive modest life insurance coverage. Traditional whole life and term insurance are far better policies in terms of straight insurance.[4] Well then, why would people want to purchase this type of insurance? The answer is easy, for investment purposes.

The concept is relatively simple. An investor pays a lump sum of money for the policy. The insurance company in return provides a modest amount of life insurance, and pays interest on the cash value, either at a fixed or variable rate. In a fixed rate policy, the insurance company will generally guarantee some stated rate, probably the competitive market rate, for a period of one to four years, depending on the policy. After this guarantee period, most policies have a floor of roughly 4%. If the investment ever hits this bottom level, the insured can cancel his policy with no surrender charges, however, he may suffer some tax consequences. In the fixed rate type of policy, the insurance company chooses how the insured's money will be invested and tries to continually earn a competitive rate of return. Insurance companies have been largely successful in recent years. For example, one accredited insurance company boasts an interest rate ranging from 10-13% between 1982 and 1986. A two and one-half year C.D. on the other hand averaged between 8-12% for the same period, and that's before taxes.[5] Thus, a single premium policy holder earned a better than average rate of return, and additionally did not have to pay taxes as this was inside buildup. However, the rate of return on a policy can rise or fall after the first year, and thus is more risky than an investment vehicle which locks in a rate of return. Of course a locked in rate of return is in itself risky, for there is the risk that the market rate of return will go above the locked in rate.

Alternatively, the insured could purchase a single premium policy with a variable rate. In this type of policy, the insured chooses how he wants the insurance company to invest his money. Thus, he may direct the insurance company to invest in stocks, bonds, mutual funds, money markets, or some other available investment. Although the insurance portion is still guaranteed, the risk of investment is much greater in this type of policy, but potential gain is also higher. With a variable rate policy, there is no guaranteed minimum return.[6]

The fact is, no matter if an insured has picked a fixed rate or variable rate, in the last couple of years single premium policies have generated substantial income. Because the inside buildup is tax deferred and the interest rates have been favorable, single premium policies have fared much better than taxable investments. This is easily illustrated by comparing a single premium policy with a taxable investment. Suppose a male age 35, in good health, has $10,000 to invest, and is in a 33% tax bracket. He can earn

8% in either a taxable investment or a single premium policy. The growth would look like this:[7]

End of Year	Taxable Investment (C.D., Bond)	Non-Taxable Investment (Single Premium)
0	$10,000	$10,000
1	$10,533	$10,800
5	$12,963	$14,693
10	$16,805	$21,589
15	$21,785	$31,722
20	$28,241	$46,610
25	$36,610	$68,486

Quite a noticeable difference! Further, it's possible that these tax deferred earnings may never be taxed. For example, if the insured lets this buildup accumulate, by definition under Section 7702 of the code, the death benefit will also have to increase in some proportion. Thus, on the insured's death, the beneficiary will receive these death benefits, all of which will be tax free. Essentially, through the insured's use of tax-deferred accumulation and income shifting, he has generated income that will permanently escape income tax. The example clearly illustrates the advantage of tax deferral offered by single premium life insurance. However, it is important to remember that all that glitters is not gold. The initial premium payment will have to cover the cost of mortality and any hidden loading costs. Thus less than $10,000 will actually be invested. Companies boasting high interest rates may be fooling investors by burying loading costs. Thus, even though an insured can earn a high rate of return, his earnings may be small if there is not a substantial amount leftover to invest. In fact, an insured might earn more from a company who has a more moderate rate of return, but very few loading charges. In other words, investors should look beyond interest rates. Secondly, the example assumes a favorable interest rate. Once again, investors should keep their wits about them and remember that these rates are not locked in. Therefore, if bad times arise, an insured's rate of return could be substantially lower than illustrated. Well, now that we have explored how the investment component operates, we can turn our focus to examine how single premium policies are an abusive tax shelter.

The essential abuse in single premium whole life is the ability of the insured to reach substantial investment income tax-free. This is accomplished through tax-free withdrawals and loans. Money that is withdrawn from the policy is presently taxed on a fifo method, i.e., basis first and then income. Thus, upon accumulating tax deferred earnings, an insured can reach these earnings tax free. However, there are some limitations. First, any amount withdrawn in excess of the initial premium payment, less any previous withdrawals, is taxable in full. Second, a withdrawal reduces the policy's cash value, which has the effect of slowing down the inside buildup. Additionally, insurance policies tend to limit the amount that can be withdrawn by imposing penalties. Finally, there are some exceptions in which a withdrawal of basis may be taxable, especially in the first 15 years of this policy. This is due to the stringent definition of a life insurance policy under section 7702 of the internal revenue code. The fact remains, however, that some amount can be withdrawn tax-free, thereby acting as an inducement to investors looking for a tax shelter.

However, by far the largest inducement to investors is the low cost availability of tax-free loans against the policy. The word loan is deceiving, however, because an insured who takes out a loan need never repay it. For example, if the insured dies without having repaid the loan, the company will simply reduce the death benefit to the beneficiaries. Assuming the insured has bought the policy for investment purposes and not insurance, this shouldn't bother him at all. Presumably, his beneficiaries are well provided for through more traditional life insurance policies. The tax-free death benefit received by the heirs of the insured from single a premium policy is simply "the candle on the cake."[8] The same concept applies if the insured surrenders the policy without repaying an outstanding loan. In that case, the insurance company simply reduces the surrender value of the policy. Thus, in essence the loan works like a withdrawal. However, a loan is even more advantageous to investors than are withdrawals. First, subject to one exception, loans are always a non-taxable event, even beyond recovery of basis. The exception to this is simply that if the insured borrows against all of the interest and a substantial portion of the principal (generally about 90% of the cash value), the policy may lapse (surrender), thus causing all of the accumulated interest to become immediately taxable. However, insurance companies are quick to alert the insured of a potential problem and generally help him avoid these dire consequences. Further, a loan, unlike a withdrawal, does not reduce the cash value of the policy. Thus, in essence, the cash value acts as collateral for the loan. This has the advantage of allowing the inside buildup to grow as strong as ever, and additionally, it gives the insured tax-free access of the accumulated earnings. However, because this is a "loan," the insured must pay some interest. The interest paid by the insured is really a "net" interest rate, for while the insured is paying interest on the loan, he is also receiving interest on his cash value.

Generally, for the insured to borrow against the inside buildup is very inexpensive. Most policies charge either the same interest rate that the insured is earning, or a rate 1-2% higher than that what the insured is earning. In any case, the net interest rate on the loan is usually between 0-2%. The rate does increase slightly if the insured borrows against the principal, i.e., initial premium payment. In this situation, the net interest rate on the loan generally falls somewhere between 2-4%, although some policies allow the insured to dip into 10-15% of the principal before the higher interest rate kicks in. One factor that has made these loans somewhat less attractive as of late is the fact that TRA cut out the deduction for consumer interest. To the insured, this means he can no longer take a tax deduction for interest paid on a loan against his policy. Additionally, loans could prove to be very costly if the policy is surrendered. This is due to the fact that often the interest charged on the loan is not paid by the insured. Rather, he might borrow the money from his policy. The interest is rarely paid off and therefore continues to compound annually. Over a period of years, this could cost the insured a substantial amount of money. Thus, surrendering the policy could prove to be very expensive. However, the tax-free recovery of income and favorable interest rates have made it relatively easy for the insured to overlook these factors.

At this point a few examples can illustrate exactly how the concept of tax-deferral, income shifting and tax-free loans can be used to fully enjoy the benefit of single premium life insurance.

First, it can be used to plan for retirement. Suppose a 55 year old man pays a single premium of $25,000. (Remember, generally any amount can be deposited over $5,000.) This might buy him $75,000 worth of insurance. At age 65, upon his retirement, the policy will have a cash value of $54,000, assuming an 8% compounded growth rate. He could now borrow $4,320 a year against his policy at a very minimal interest rate, and he will pay no taxes. His cash value is not reduced and therefore continues to grow steadily. He can virtually make this tax-free withdrawal every year until he dies. On his death, the insurance company will simply reduce the death benefit payable by the amount he owes.[9] This reduced cash value is referred to as the cash surrender value.

Single premium whole life can also be used to fund a college education. Assume a non-smoking male age 30, in good health, pays $18,000 for a policy upon the birth of his child. For purposes of illustration, an 8% interest rate is once again assumed. Upon the child's 18th birthday, the father can take out $10,000 a year for four years. This will be accomplished tax-free, through withdrawals and loans. A withdrawal (basis first) will be taken the first year, to avoid any interest payments, followed by three loans of $10,000 each. Additionally, should the father die prior to the child's college years, the death benefit which will pass tax-free, can be used to pay for the child's education. Thus, the child's education is secure. Further upon retirement, the insured could take additional loans. The calculations are as follows:[10]

Policy Year End	Father's Age	Cash Taken Out	Taxes Due	Theoretical Cash Value	Surrender Value of Policy	Net Death Benefit
1	31	0	0	0	$ 18,403	$ 81,745
19	49	$10,000	0	$ 59,843	59,843	167,878
20	50	$10,000	0	64,480	53,595	157,878
21	51	$10,000	0	69,493	46,760	147,058
22	52	$10,000	0	74,904	39,277	137,029
30	60	retirement	0	135,732	65,756	178,917

This clearly illustrates the major advantages of single premium policies, especially when considering all this only costs on initial $18,000.

The last major inducement to single premium policies is that the underwriting seems to be very liberal. It seems that most people who apply qualify. Ratings are of a minor consequence, for it will simply lower the death benefit and not the return to the insured. According to one company, "Normally, you will qualify without a physical examination."[11]

Single premium life insurance is not without disadvantages however. First and foremost, unlike stocks, bonds, and savings accounts, this is not a liquid investment, which is why the insured is not viewed as having constructive receipt of the earnings. For example, it can be extremely expensive to surrender a policy. In the early years there are surrender fees. During the first seven or eight years, these fees can be quite expensive. The average penalty starts at 8% in year one, and declines by 1% each year until it vanishes in the eighth year.[12] Thus, it can be expensive to cash in early. Each policy is different in terms of what triggers a surrender. However, once the surrender charge vanishes there are still some serious problems. If the policy is surrendered, the accumulated earnings become taxable. After eight years or so, this could amount to a substantial tax burden. These realities make single premium policies a long-term investment, at least for part of the original deposit. One executive is quoted as saying, "Unfortunately people without much money usually have emergencies come up where they need money, [but] it takes a lifetime to get hold of all the tax advantages and benefits, so we try to get people to buy single premium life only if they think they can keep it for life."[13] A further shortcoming is that interest rates are generally not guaranteed beyond a year or two. Thus, projected performances are simply that, projections. Interest rates can increase or decrease unexpectedly at any time. There also may be some hidden costs in administering loans and withdrawals, and as already discussed, initial loading costs which cover commission fees and other administrative costs. Finally, the cost of mortality could fluctuate and require either a further premium deposit, or surrendering the policy, a no-win situation in either case.

Although the sales of single premium policies have skyrocketed over the last two years, Congress and the Treasury Department have been investigating the potential abuse of life insurance contracts for a number of years. In 1982 some technical reforms were made, and in 1984, life insurance was more closely scrutinized, resulting in some significant changes.[14] The most noticeable change was in the stricter definition of life insurance under Section 7702 of the code. Despite these changes by Congress, however, the Treasury Department was still concerned about the favorable tax treatment of life insurance policies, more specifically, the tax-free growth of inside buildup. Due to increasing interest rates and the deregulation of financial institutions, the Treasury Department felt life insurance products were heavily investment oriented. They became very concerned with the number of people turning to life insurance products for investment purposes. Further, they felt it was unfair to give life insurance products favorable treatment not afforded comparable investments. Finally, the Treasury Department felt that this tax-deferal advantage was taken advantage of only by individuals with substantial disposable income. Additionally, they felt the advantage was being abused.[15]

On May 25, 1985, the Treasury Department introduced a proposal to do away with the special treatment that life insurance receives.[16]

Quite simply, the proposal was designed to tax the annual increase in the inside buildup. The proposal viewed owners of life insurance policies as having constructive receipt of the cash value. Thus, the investment earnings would be currently taxable. The Treasury Department felt this would eliminate tax distortion, eliminate the need for complex rules and restrictions, and generate substantial revenue for the government. It is important to note that the proposal pertained to all life insurance policies, and not just single premium policies. However, due to intensive lobbying efforts by a united life insurance industry, the proposal was defeated. This was quite an accomplishment considering how most tax shelters fared under TRA.

The industry made several arguments in opposition. First, the industry urged that life insurance is not comparable to traditional investment vehicles. Rather, they argued that life insurance is bought to provide families with financial protection against the risk of death, not to achieve investment return. This argument is somewhat weak, for "the law taxes income, not intention."[17] The industry also argued that the cash value of a policy cannot be reached except by giving up "valuable rights," and therefore the owner does not have constructive receipt of the earnings. The industry drew the analogy of trying to tax the yearly increased value of a home. Of course, they failed to recognize the difficulties of valuing the yearly increases in a home, not to mention the fact that those increases essentially cannot be reached without selling the home. The next major argument by the industry was that the Treasury's proposal would hurt lower and middle income people far more than upper income people. The industry feared that these people would have to pay taxes on money they didn't have. Further, because taxing inside buildup would act as a disincentive, the industry argued many widows and children would be left without proper financial support. Some other rebuttals to the proposal included: the severe loss of jobs that would occur throughout the industry; the resulting reduction of capital investment and formation by life insurance companies that is vital to economic growth; taxing the inside buildup would conflict with the goal of tax simplification as it would require more records and calculations; the proposal ignores how much change has already occurred throughout the industry and it is not fair to the industry to be put through it again.[18] Overall, the industry strongly objected to a comparison of life insurance with traditional investment vehicles such as savings accounts, certificates of deposit, money markets, stocks and bonds.

Although not all of the industry arguments are very compelling, Congress was persuaded not to accept the Treasury proposal. This is probably due to the fact that not all life insurance policies are abusive. For example, whole life policies purchased by middle and lower income classes probably are purchased for future protection, and not for investment purposes. These people would have been hurt severely by taxation on buildups. They would be paying taxes on money they do not have, and they probably would have been forced to reduce the financial protection that they could afford. However, it could be argued that term insurance is available and could be purchased with the amount traditionally invested. Although this too is not without a flaw, for in later years, term insurance could be very expensive and difficult for lower income individuals to afford. Overall, congress felt taxing the inside buildup would hurt too many people and therefore TRA was passed without this proposal.

As already noted, TRA did away with many other tax shelters. Because of this, many investors had to look elsewhere for investments. The life insurance industry made it no secret that single premium whole life insurance was an attractive alternative. People could deposit money, accumulate earnings tax-free and access these earnings through tax-free loans and withdrawals. Additionally, they could get some extra life insurance protection in which a death benefit passes tax-free. Life insurance companies have marketed single premium policies in this way. One life insurance brochure quotes U.S. News and World Report on its cover. It reads, "hailed as the hottest tax free investment on the market."[19] Another reads, "The product is primarily designed for accumulating money, not to provide life insurance protection."[20] Many companies have run advertisements which blatantly focus on the tax shelters available through single premium policies, with very little mentioned about insurance. On its face, however, single premium insurance really isn't abusive. In other words, there is nothing wrong with the idea of wanting to pay in advance for all future life insurance protection. The problem is due to the way these policies are marketed and abused by insurance companies. Additionally, stockbrokers have also added to the problem by promoting single premium policies as an investment.[21]

Although the Treasury proposal to tax the inside buildup failed, most industry officials believe some reform for insurance is inevitable. At least one company has provided for the contingency by stating "If SPAL is adversely affected by an act of Congress, we will allow a no-cost rollover of the cash value without evidence of insurability."[22]

It appears the industry is correct, for Congressman Pete Stark (D-Cal.) is pushing vigorously to stop the abuse. Joined by Congressman Bill Gradison (R-Ohio), Stark introduced a proposal, H.R. 3441, to stop the abuse in the life insurance industry. The proposal is aimed at curbing the abuse of single premium policies. Stark suggests that single premium policies are largely purchased by upper income people who have some extra cash to invest. Supporting this is the fact that most policies have a $5,000 minimum deposit indicating that single premium policies are not geared towards middle or lower income individuals. Stark insists that these purchasers are not buying single premium policies for life insurance protection. Rather, he argues that the insured's sole intention in purchasing single premium life is to shelter income. As noted earlier, Stark claims that sales of single premium policies have increased over 60% since 1985, pre TRA. He also notes that sales of traditional life insurance policies have remained stable. Thus, he draws the obvious conclusion that there is not a sudden craze toward life insurance, but rather a craze to find remaining tax shelters.[23]

Stark's proposal, H.R. 3441, has three primary provisions. First, distributions under life insurance contracts would be treated as income first and as recovery of basis second. Next, loans under life insurance contracts would be treated as distributions subject to taxation to the extent of investment income under the contract. Finally, an additional 10 percent tax would be imposed on the portion of any distribution or loan under a life insurance contract that is includable in income. However, the additional tax would not apply if a distribution occurs: First, after the holder of the contract attains age 59 1/2; or second, on account of the holder's disability; or third, as part of an annuity-type distribution over the holder's life expectancy. These rules are essentially the same rules that apply to distribution from annuity contracts, qualified provision plans and Individual Retirement Accounts. Further, the bill was introduced with a grandfather clause, dated October 7, the date the bill was introduced to Congress. The proposed bill would apply only to loans and withdrawals made after October 7, 1987, but only to the extent the amount distributed is not allocable to investment in the contract on or before that date.[24] A spokeswoman for Stark explained that essentially insurance companies would treat all money in the contract prior to October 7, 1987 as "old" money, and all premium and interest credited to the contract after October 7 as "new" money. For example, assume an insured deposited $10,000 as his initial deposit and earned $5,000 through October 7, 1987. After October 7, he decided to deposit $2,500 more and earned another $2,500. In this case, the first $15,000 withdrawn or taken as a loan will be treated as "old" money and not subject to the Stark proposal. Anything above this $15,000 level will be treated as "new" money and will be subject to the proposal. "New" money apparently includes all interest, whether earned from a pre-October 7 premium payment or past October 7 payment. This allows for a more workable monitoring system.

Stark claims that this proposal will greatly reduce the abusive tax shelter treatment of life insurance, "while ensuring that the tax-favored treatment of life insurance continues to encourage savings for retirement and financial protection for surviving dependents."[25] However, the proposal has temporarily been withdrawn due to the life insurance industry's efforts to push for a compromise. The National Association of Life Underwriters stated that "using H.R. 3441 to end single premium life insurance advantages is a bit like using the guillotine on a headache."[26] The industry argues that in addition to attacking single premium policies, where the abuse is occurring, H.R. 3441 also attacks traditional life insurance, the kind of product most Americans own. The industry argues that these people would be hurt when they needed money most, in emergency situations.

The industry's proposed compromise apparently includes reworking the definition of life insurance under the code. Apparently, they plan to come up with a definition which would virtually eliminate single premium insurance from the definition under the code. Thus, single premium insurance would be treated like any other investment, yet the traditional life insurance product would remain unchanged for tax purposes. The result of this would be to tax the inside buildup on single premium policies annually. This would eliminate single premium life insurance as an abusive tax shelter, and yet preserve the policy goal of saving and providing financial protection for widows and children through more traditional life insurance.

Stark's proposal does have good intentions, but it does appear to be overreaching, as the industry contends. The bill could be well suited if limited to single premium policies only. Additionally, it seems that the penalty provision is unnecessary. Stark's intention behind including a 10% early withdrawal penalty is to level the playing field between single premium policies and Individual Retirement Accounts, annuity contracts, and qualified pension plans. However, the penalty for IRA's is in place due to the deduction allowed for contributions to IRA's. Thus, the penalty is in place to ensure a deduction is not taken for a contribution which is followed closely by a withdrawal. Single premium life on the other hand is different. There is no deduction for the initial deposit or contribution. Thus, a penalty for early withdrawal seems unnecessary.

The General Accounting Office (GAO) agrees with Stark that single premium policies are being abused. They have offered two suggestions to the problem. First, they would treat loans the same way distributions from annuity contracts are treated.[27] In other words, part of the loan would represent return on investment and part would be a nontaxable return of basis. This may work well in theory, but the practical effect of this would be mass confusion. Annuity payments are level over a stated number of years. Therefore, using a simple formula, it is easy to compute the exact recovery of income and basis of each payment. The same is not true with loans from life insurance contracts. Unlike annuities, it is not known in advance how much will be taken out, nor when it will be taken out. Thus it would be extremely difficult to determine how much of a loan is basis, and how much is investment income. Further, a straight percentage allocation would also not be wise. This would generally lend to one of two results. Either the insured would be greatly overpaying taxes on a loan, or the insured would be greatly underpaying taxes on a loan. For example, assume that 20% of every loan was a recovery of income. If the insured deposited $10,000, let it grow to $50,000 and then took a loan of $20,000, clearly most of that is interest, but he would only pay taxes on $4,000. The reverse would be true with a higher percentage rate. For example, should a loan be taken in the early years of the policy, the insured might pay taxes on money that is not income. The point is, no matter what percentage rate that is used, it would prove to be very arbitrary and often inequitable.

The second alternative the GAO announced seems more workable; change the definition of life insurance under the code. They would change the definition so that single premium policies would not receive tax favorable treatment. Essentially it seems that they are in agreement with the life insurance industry in that it is single premium policies which are abusive, and not life insurance in general. It should be recognized that changing the definition of life insurance to exclude single premium policies, is tantamount to a proposal that suggests to tax the inside buildup of single premium life policies only. This is important because some Congressmen fear that if this is the only action taken, it simply invites the insurance industry to design new products that avoid single-premium status.[28]

Some other proposals that have been discussed include: requiring a higher death benefit if the policy is to qualify as life insurance; require that premiums be paid for a minimum number of years, such as five or ten; or increase taxes on insurance companies in lieu of tax on policy owners.[29] The first choice seems to be a viable alternative. This would reduce the amount of premium allowed to be invested and would curb any abusive tactics simply because there would be little investment incentive. People looking for investment vehicles will probably turn to an investment in which all of their money can be working for them. The second alternative seems somewhat less attractive because it eliminates the basic premise behind single premium insurance. In other words, people could no longer pay for all of their insurance in advance. To many Americans, this would be a harsh solution. Finally, increasing taxes on insurance companies also seems to be unattractive. It doesn't go to the heart of the problem, i.e., abusive investors. If single premium policies are comparable to traditional investments, then investors in single premium policies will still be favored in comparison to an investor who holds a certificate of deposit.

It seems obvious to everyone that single premium life insurance has grown to be an abusive tax shelter. The remaining question is, what action should be taken? Taking current mortality into account, the best answer appears to be to require higher death benefits on single premium policies. In other words, require a higher percentage of premium payment to go towards the death benefit. This has three major effects. First, it will reduce the incentive to use single premium life insurance as an investment. The cash value of the policy will grow much slower because there will be a much smaller investment component. However, it will still allow people to take tax-free loans and withdraw in emergency situations. Second, the standard goal of life insurance will still be promoted; to act as an incentive for people to save, and to provide financial protection for dependent's upon the insured's death. Finally, it still enables individuals to prepay their insurance without being penalized. Should the definition of life insurance be changed so as to exclude single premium insurance, this last class of individuals would be penalized, for they would have to pay tax on the annual income. Surely, this would change their thoughts about any prepayment ideas through single premium policies.

A slightly stricter proposal would be to tack on part of the Stark proposal. Thus, not only would there have to be an increase in the death benefits provided, but withdrawals and loans would be taxable to the extent they are income. Of course theoretically, with the increased death benefits, there would not be a large amount of income generated in which to tax. However, what little is generated would be taxable upon either such event. Although this might hurt an investor in an emergency situation, we are reminded once again that "the law taxes income, not intention."[30] Thus, according to this theory, it should be irrelevant why the insured needs the money, if it is income it should be taxed. If this part of the Stark proposal were adopted, it should be noted that under this line of thinking, withdrawals and loans from traditional policies would have to be treated similarly. Thus, although it would leave a small advantage or loophole, it may be best to simply treat withdrawals and loans as they have been treated in the past. This will allow all policyholders free accessibility to emergency funds.

Finally, changing the definition of life insurance is a third possibility. However, if it is done, it should be done in such a way that eliminates any potential for the industry to design another abusive product. It should be kept in mind, however, that changing the definition will harm those individuals who simply want to prepay their insurance, with no intention of using the policy as an investment vehicle.

It is clear that the abuse of single premium life insurance calls for some action. Requiring a substantially higher death benefit should stop the present abuse of using single premium policies as a tax shelter. Thus, the final question seems to be, where will investors turn next?

Footnotes

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26. See supra, note 22, "War of Words."

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29. Id.

30. See supra, note 16.

STATEMENT OF RAYMOND L. BRITT AND MARY V. HARCAR TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES COMMITTEE ON WAYS AND MEANS OF THE HOUSE OF REPRESENTATIVES

This memorandum is intended to discuss an alternative to H.R. 3441*, which would tax all life insurance policy "distributions" (policy loans, withdrawals) on a basis similiar to that presently imposed on distributions from annuity contracts prior to annuitization. Under the H.R. 3441 rule, all "distributions" would be taxed on a LIFO basis. The proposed alternative approach discussed herein is premised on the following assumptions:

1. That the abusive "tax shelter" aspect of single premium policies is the ability of the policyholder to invest large sums of cash in such policies (which like all life insurance policies are not currently taxed on the inside build-up) while simultaneously withdrawing a significant percentage of such invested cash at no "tax cost" to the policyholder;

2. That Congress does not view all policyholder loans as abusive and is not interested in eliminating the availability of policyholder loans in general; and

3. That Congress is not interested in eliminating the use of a single premium life insurance contract to provide death benefits that are excludible from income pursuant to section 101 of the Internal Revenue Code (the "Code").

It is submitted that a single premium life insurance policy is not an inherently bad vehicle for some individuals to use when purchasing life insurance protection or for estate planning. Some individuals want to make one payment to provide for their needed life insurance coverage. The purpose of such a single payment purchase is not the ability to borrow upon the policy during the lifetime of the insured. For example, under a Single-Premium, Variable Life policy, the policyholder's premium is invested in selected series funds and the amount of death benefit is directly or indirectly based on the value of the series funds at the time of death of the insured. A cash loan under such a contract reduces the policyholder's investment in one of the series funds and thus has a significant effect on the ultimate death benefit. While policy loans are allowed under these policies, that ability is not a significant feature of the policy. Such a policy is an excellent purchase for estate planning purposes by an individual whose investments consist mainly of equities and real estate, such that the amount of the death benefit and value of the estate are kept in step. Favorable tax treatment should remain available for such contracts designed primarily for insurance purposes. In contrast, the purchase of a single premium life insurance policy for the purposes of both sheltering the inside build-up under the policy and having use of that sheltered income at no tax cost during the lifetime of the insured is an abuse of the present rules for the taxation of life insurance under the Code (sections 72, 101, 264, 7702).

Our approach to curb the use of single premium life insurance as a tax shelter does not involve the modification of the definition of life insurance under section 7702 of the Code. For those individuals that desire to pay a single premium for life insurance protection, such a policy should be available and the policyholder should not have to worry whether his or her policy meets a new definition of life insurance. The consequences of a policy not meeting the definition of life insurance are quite harsh, and a policyholder should not have to worry about such consequences. Again for example, a Single-Premium Variable Life policy, even though it is purchased for a single premium, offers the policyholder an opportunity to purchase family protection and, since it meets the present definition of life insurance and is not generally used for lifetime withdrawals, it should be an insurance policy available for purchase by the public. Our approach eliminates the abusive aspect of a single premium policy: the ability to withdraw tax sheltered income from the policy during the lifetime of the insured at no tax cost to the policyholder.

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* H.R. 3441 was introduced in the House by Rep. Fortney H. (Pete) Stark and Rep. Willis D. Gradison on October 7, 1987, as a proposed amendment to the Internal Revenue Code of 1986. The bill was intended "to alter the Federal income tax treatment of loans and other pre-death distributions under life insurance contracts....... .[and was] designed to curtail the use of life insurance as a tax-favored investment vehicle by limiting the ability of policy holders to withdraw amounts tax-free from insurance contracts prior to death." H.R. 3441, 100th Cong., 1st Sess., 133 Cong. Rec. H8289-90, H8307 (1987).

We recommend the following:

1. Establish a definition of a "single premium life insurance policy".

Subsection 264(b) of the Code already contains a definition of a single premium life insurance policy. The purpose of section 264 is to deny an interest deduction on indebtedness incurred either to purchase or carry a single premium life insurance policy. For the purposes of section 264, subsection 264(b) provides that a contract will be treated as a single premium life insurance policy if "substantially all the premiums on the contract are paid within a period of four years from the date on which the contract is purchased". While such a definition appears adequate for the purposes of section 264, we are of the opinion that it would not be adequate for the purposes of controlling the use of single premium policies as tax shelters. Unless the premium per thousand of insurance is somehow controlled, a contract with an unusually high premium per thousand could require the payment of a sufficient number of premiums to ensure that "substantially all" premiums are not paid within a period of four premiums (generally five or six premiums), thus allowing the policyholder to shelter a larger amount of investment income with the ability to remove such tax sheltered income with no tax consequences.

We have reviewed the proposal put forward by NALU and AALU as a solution to the single premium issue, in particular their development of a "Amount-Paid-In" test. While we would not recommend the modification of section 7702 to include an additional "Amount-Paid-In" test for qualification as a life insurance contract for the reasons discussed above, some form of the "Amount-Paid-In" test would be appropriate as a definition of a "single premium policy". Section 72 could be amended to add the definition of a "single premium" policy.

2. Amend subparagraph 72(e)(5)(C) to provide that the rules that presently apply to withdrawals of cash from annuity policies prior to annuitization shall apply to amounts received from single premium contracts.

Subsection 72(e)(5)(C) should be amended to state:

"Except to the extent prescribed by the Secretary by regulations, this paragraph shall apply to any amount not received as an annuity which is received under a life insurance contract (other than a single premium life insurance contract as defined in section 72) or endowment contract".

Subsection 72(e)(5) generally provides that the LIFO rules that apply to withdrawals of cash (including policy loans) from annuity policies prior to annuitization shall not apply to life insurance and endowment contracts. Thus, policy loans from life insurance policies are generally not subject to LIFO rules, and such loans are not taxable to the policyholder unless the policyholder surrenders the policy prior to the death of the insured. Amendment to this subsection to make the LIFO rules presently applicable to policy loans on annuity policies also applicable to single premium life insurance policies will terminate the ability of a policyholder to receive distributions of tax sheltered income under single premium life insurance policies without tax consequences.

3. Amend subsection 72(q) to provide that withdrawals of cash from single premium life insurance policies will be subject to a 10 percent premature distribution penalty.

Premature distributions under annuity contracts are presently subject to a 10 percent penalty tax pursuant to subsection 72(q). Our approach is basically to treat withdrawals from single premium life insurance policies in a manner similar to that afforded distributions from annuity contracts prior to annuitization. This would include the imposition of a 10 percent penalty. We recommend adding a paragraph to subsection 72(q) as follows:

"If any taxpayer receives any amount under a single premium life insurance policy, as that term is defined in this section, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income."

* * * * *

Our approach attacks what we understand to be the abuse of single premium life insurance: the ability to receive distributions of tax-sheltered income free of tax consequences during the life of the insured. Single premium policies are life insurance if they meet the present definition of life insurance established under section 7702 of the Code and satisfy current law requirements designed to limit the investment orientation of the contract. We see no need to amend section 7702 and make it even more complicated if the abuse from ownership of a single premium policy can be negated in a more straightforward, practical and simpler manner. Our proposal will eliminate the widespread use of the policy loan feature in both single premium, whole life policies and single premium variable life policies, thus eliminating the policies' attractiveness as an investment, while allowing these policies to continue to be used for legitimate insurance purposes.

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March 15, 1988

STATEMENT OF
THOMAS L. STAPLETON
SENIOR VICE-PRESIDENT AND TAX DIRECTOR
FOR METROPOLITAN LIFE INSURANCE COMPANY
HEARINGS OF
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS
ON
INVESTMENT USES OF LIFE INSURANCE
MARCH 15, 1988

Outline of Statement

I. Discussion of Concerns & Proposals
II. Recommended Combined Approach

There is growing concern about the potential for tax abuse that may exist with respect to single premium life insurance contracts. Some of these contracts, while enjoying the tax status afforded permanent life insurance, may be structured and marketed as short term investment vehicles or as a way of providing tax sheltered funding for consumer purposes. Although constrained by the carefully drawn definitional rules for life insurance enacted in 1984 which strictly limit contract investment orientation, these contracts may still promise a substantial return which can be drawn out free of tax periodically through policy loans.

Substantial sales of heavily advertised single premium life insurance contracts occurred in 1987. Nevertheless, these contracts represent only a small portion of the permanent life insurance in force in the United States. The great bulk of permanent life insurance, including many single premium contracts, is purchased with a view to affording life insurance protection and death benefits to dependents. It is important that this be kept in mind in analyzing the problem.

Two approaches for dealing with problem contracts have been advanced. The first (H.R. 3441) takes a "distributional" approach. It would change current law distribution rules for all permanent life insurance contracts. Policy loans would be considered distributions and distributions would be taxed on a LIFO "interest first" basis. Further, with certain exceptions, an additional 10% penalty would be imposed on distributions. In our view, rather than targeting the problem, this proposal goes needlessly beyond it. It would extend to all permanent life insurance contracts not merely single premium or other problem contracts. Millions of permanent life insurance policyholders with contracts purchased for the primary purpose of providing death benefits to their dependents would face additional taxes and penalties on their policy loans.

A second proposal, advanced by the National Association of Life Underwriters (NALU), takes a "definitional" approach to the problem. Based on statutory mortality charges and specified interest and expense charges, it would set a maximum premium per thousand dollars of life insurance that could be paid into a contract during its first five years. This amount would be tied to the premiums that could have been paid under a whole life contract providing for five level premiums. If a contract failed to meet this test it would not qualify under the definition of life insurance. This proposal makes no distinction between single premium contracts held for life insurance protection and those contracts used as short term investment vehicles utilizing policy loans. In our view, this proposal also goes too far. Single premium life insurance is not an inherently bad vehicle for individuals to use when purchasing life insurance protection or for estate planning. Our own Company has records of single premium life insurance contracts going back at least as far as 1917. Some individuals want to make one payment to provide for their needed life insurance coverage. This flexibility is worth preserving and these policyholders should be protected so long as there are no tax abuses.

We urge that you reject overly broad solutions, the fallout from which would discourage policyholders generally from securing life insurance protection. We recommend instead that you consider a carefully targeted "combined approach". This approach would combine in one solution some but not all elements of both definitional and distributional approaches. The combined approach would work in the following way: First, a definitional test would be used to define those contracts which although meeting the definition of life insurance have sufficient investment orientation to be susceptible to distribution abuses. Distributions, including policy loans under these contracts, would then be subjected to tougher tax rules. All other contracts would be left alone. Current rules would apply to them.

There are a number of definitional tests which could be considered. These tests include not only the NALU test but tests which would calculate premiums differently using assumptions now permitted under Section 7702 and tests grounded in the current definition of single premium life insurance in Section 264 of the Code. Similarly, there are a number of possible approaches to distributions from contracts that fail the definitional test. While we are opposed to penalties, we believe that subjecting loans and other distributions under those contracts which fail the definition test to LIFO "interest first" rules for a period of time should be considered. By combining the definitional and distributional approaches, problem contracts would be defined and distributions under those contracts dealt with more strictly. The remainder of permanent life insurance contracts would not be disturbed.

The combined approach should apply only to new contracts issued after enactment of any change. Congress fashioned careful and complex rules governing the definition of life insurance in 1984. Policyholders who purchased life insurance contracts relying on compliance with current law, should not be subjected now to a change in the rules. The interests of fairness as well as the need to avoid substantial administrative problems support making any change applicable to new contracts only.

We would be pleased to work with the Subcommittee and staff in any way that would be helpful on the details of a combined approach. We appreciate the efforts of the Subcommittee to deal with a complex problem in a careful and constructive way that protects policyholders and contracts that are not part of the problem.

MIDLAND

JACK L. BRIGGS
VICE PRESIDENT, SECRETARY
& GENERAL COUNSEL

March 31, 1988

Subcommittee on Select Revenue
Measures, House Committee on Ways
and Means
Room 1102 - Longworth Building
Washington, DC 20515

Taxation and Debt Management
Subcommittee, Senate Finance Committee
Room SD-215 - Dirken Senate Office Building
Washington, DC 20510

RE: Investment Uses of Life Insurance - Single
Premium Life Insurance

Gentlemen:

On March 15, 1988 Richard S. Schweiker, President of the American Council of Life Insurance (ACLI), delivered the enclosed testimony** at the hearings of the Subcommittee on Select Revenue Measures of the House Ways and Means Committee. Mr. Schweiker presented the views of the ACLI on the investment uses of life insurance, and specifically the single premium life insurance product.

As a member of the ACLI and the largest life insurance company in the State of South Dakota, we would like the record to show that we support and endorse the position of the ACLI.

Thank you for considering our input and for including it in the official record of your hearings on this subject.

Cordially,

Jack L. Briggs
JACK L. BRIGGS
Vice President, Secretary
and General Counsel

nd
enclosures

** SEE WRITTEN STATEMENT OF RICHARD S. SCHWEIKER.

MNL MIDLAND NATIONAL LIFE INSURANCE COMPANY • ONE MIDLAND PLAZA • SIOUX FALLS, SD 57193 • (605) 336-5700

STATEMENT OF
THE NATIONAL ASSOCIATION OF LIFE COMPANIES AND THE LIFE INSURERS CONFERENCE FOR THE RECORD OF THE HEARING BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES ON LIFE INSURANCE CONTRACTS

The National Association of Life Companies (the "NALC") and the Life Insurers Conference (the "LIC") are pleased to have this opportunity to present our views on the Federal income tax treatment of life insurance contracts. The NALC, with headquarters in Washington, D.C., is an association of over 500 life insurance companies domiciled in 48 states. Operating out of Richmond, Virginia, the LIC is an association of 70 insurance companies. LIC and NALC companies are predominantly small- to medium-sized companies which provide life insurance products to over ten million policyholders. We respectfully request that our statement be included in the record of the hearing held on March 15, 1988, by the Subcommittee on Select Revenue Measures.

The press release announcing this hearing indicates the Subcommittee is concerned that the definition of life insurance adopted by Congress may not be "curtailing the purchase of life insurance principally as an investment or as funding for consumer purposes rather than, as intended in the 1984 legislation, a means to provide death benefits for dependents." NALC and LIC believe that the present definition properly distinguishes between those policies which serve as vehicles for life insurance protection and those which are investment vehicles. We would urge this Subcommittee to follow the old adage -- "if it isn't broke, don't fix it."

The definition of life insurance was added to the Code in 1984, following this Subcommittee's two-year study of life insurance companies and their products. During this period, the tax treatment of life insurance contracts was carefully reviewed and, because of concerns that some life insurance products were too investment oriented, the various types of life insurance contracts, including single premium policies, were studied extensively. The Subcommittee's review culminated in the enactment of Internal Revenue Code section 7702 which defines a life insurance contract for Federal tax purposes.

Section 7702 provides that only those policies which meet one of two alternative tests can qualify as life insurance contracts for tax purposes: (1) a cash value accumulation test, or (2) a combination guideline premium and cash value corridor test. The cash value accumulation test provides that at no time may the cash value of a policy exceed the "net single premium" which will permanently purchase the policy's death benefit. The guideline premium test requires that the premiums paid for a policy may not exceed the greater of the single premium or the cumulation of level annual premiums needed to purchase the death benefit. It further requires that the policy's cash value may not exceed a specified percentage of its death benefit -- the so-called "corridor" requirement. Life insurance policies which meet the requirements established under section 7702 are not taxed on the inside build-up. A policy which fails the requirements is considered to be an investment product and its gains are taxed currently.

We believe that the definitional tests in section 7702 strike the appropriate balance between the investment features and the insurance features of all life insurance policies. Present law recognizes that the investment component of a life insurance policy is integrally related to the protection component and that it is the investment component which serves to level and reduce the overall costs of permanent policies. Without such a component, policyholders would face ever increasing costs for insurance -- costs which ultimately would be prohibitive for many older individuals. In recognition of this fact, premium payments under permanent life policies are designed to permit the consumer to select the terms most suited to his or her financial circumstances. Section 7702, as crafted by the Subcommittee, accommodates these variations by focusing quite properly on the relationship between the funds accumulated in a life insurance contract and the benefits provided under the contract, not on the mode of premium payment.

During the last year, attention again has focused on the tax treatment of life insurance contracts, and in particular, single premium life insurance policies. We understand that an increase in sales of single premium life insurance policies and recent advertisements promoting the investment aspects of such policies have led this Subcommittee to question whether the value of a single premium contract lies with its life insurance protection or with its investment returns. We submit, however, that in spite of some misguided advertisements, single premium life insurance provides the same valuable function as other forms of life insurance -- financial security for families. Moreover, we believe that once the nature of single premium life insurance policies is understood, this Subcommittee will agree that the present-law treatment of such policies is correct.

First of all, single premium life insurance is a traditional form of life insurance which has been available in the United States for decades. Indeed, single premium policies differ very little from other forms of permanent life insurance, except that they are purchased with one premium payment rather than a series of payments. Like all life insurance policies, a single premium life insurance policy guarantees that the insured's beneficiary will receive a death benefit substantially greater than the premium paid for the policy. In addition, like all other permanent life insurance contracts, a single premium policy has a cash surrender value as required under the Standard Nonforfeiture Law (which is in effect in all states). The Standard Nonforfeiture Law further requires that a policyholder who discontinues making premium payments be given the option to purchase extended term insurance or to use the contract's cash value as a single payment to purchase a paid-up life insurance policy in a lower amount. Thus, as mandated by uniform state laws, all permanent life insurance policies may be converted into a single premium life insurance policy at the policyholder's option.

Like all other permanent life insurance policies, single premium policies are required by state law to have a policy loan feature. Under the policy loan provision, life insurance companies are required to make available to the policyholder an amount equal to the cash surrender value of the policy. The company can charge interest on that loan at a specified rate which is limited by state law. The policyowner may repay the loan in whole or part at any time. If, however, the policyowner has not repaid the loan at the time the insured dies, the amount of death benefits payable to the insured's beneficiary will be reduced by the amount of the outstanding loan and any unpaid interest.

Thus, with the exception of the mode of payment, the single premium life insurance policy is indistinguishable from other forms of cash value life insurance. And, individuals purchase single premium life insurance policies for the same reasons that insurance is purchased generally -- a guarantee of lifetime insurance protection combined with long-term savings. The single premium method, however, offers the purchaser certain advantages wholly independent of the deferral of tax on the savings component.

The obvious advantage of purchasing a permanent life insurance policy with one premium is that the owner obtains a fixed amount of life insurance protection without the necessity of further premium payments. In addition, the cost of the protection purchased will be less than if the purchaser had spread the premiums over a longer period of time. Such difference in cost reflects the fact that higher expenses are incurred by a life insurance company in connection with multi-premium policies. The higher cost of multi-premium policies also is attributable to the fact that the purchaser has the use of his or her money prior to each premium payment.

Despite the fact that single premium life insurance policies share the same characteristics as other forms of permanent life insurance, some have proposed that the tax definition of life insurance be amended to exclude single premium policies. One such proposal has been offered by the National Association of Life Underwriters. Under the NALU proposal, section 7702 would be modified so as to require that, in order to be treated as a life insurance policy, a policy's guaranteed death benefit could be purchased no more rapidly than with 5 level, annual premiums (the "5-pay rule"). The proposal also would include new statutory restrictions on the mortality costs and the expense load used to calculate the 5 level premiums.

This Subcommittee considered and rejected the use of a minimum spread pay requirement during its study of life insurance products in the 98th Congress. The NALC and the LIC strongly opposed the adoption of such a proposal then, and we believe that the problems identified at that time remain. If the NALU proposal, or a similar proposal, were adopted, a life insurance policy which qualified as life insurance when purchased would lose its qualified status if an individual's financial circumstances changed and he or she allowed the policy to lapse into paid-up coverage at a reduced death benefit (an option required by all states).

Furthermore, the spread-pay requirement and the expense limitations as proposed by NALU could prohibit the sale of other legitimate insurance products, such as burial insurance policies. We are not aware of any suggestions of abuse with respect to the purchase of burial insurance, yet, the new definition of life insurance as proposed by NALU could result in the disqualification of many of such policies.

The NALU approach also introduces an element of price regulation into the definition of life insurance by placing restrictions on the charges that a life insurance company can impose for the mortality risks it assumes under a life insurance contract, as well as the expenses which can be reflected in the premiums charged. Adoption of such price regulation is unprecedented and totally out of place in the tax law.

A number of advertisements for single premium life insurance have emphasized the loan features of life insurance policies. We understand that this Subcommittee is concerned that these advertisements may indicate that such policies are purchased for this feature, and not for insurance protection. Although, of course, single premium policyowners do have the state mandated right to borrow from their policies, that ability is hardly the central feature of the policy. As stated above, the purchase of a permanent life insurance policy with one premium provides advantages which extend beyond the policy's cash value. Furthermore, we do not believe that the record shows that single premium policies are purchased primarily for this reason. To our knowledge, policy loan activity has not increased in general, nor has there been an increase in policy loans under specific classes of policies.

Nevertheless, it has been suggested that, in order to prevent excessive policy loan activity on all policies, it might be appropriate to amend the tax laws to include in income pre-death distributions from a life insurance policy. A bill introduced by Congressman Stark and Congressman Gradison would take such an approach (H.R. 3441). H.R. 3441 would tax all distributions from all life insurance policies, including loans, using an income first rule rather than the present-law cost recovery first rule. In addition, a penalty tax would be imposed on premature distributions. Only limited grandfathering rules would be provided.

We believe such a proposal is premature in that it addresses a perceived problem that is not documented by the facts. Furthermore, these changes could discourage individuals from providing for the long-term financial security of their families. Sixty-eight percent of permanent life insurance is purchased by individuals earning less than $30,000. These individuals may be less likely to purchase the insurance if their ability to borrow against the policy in the event of financial need is subject to tax and penalties.

We do not believe that the broad changes proposed in H.R. 3441 are justified. The present-law rules have been in effect since the inception of the income tax. The only rationale for creating a taxable event in the case of a loan is to equate the loan with a sale or distribution of the value of part or all of the underlying collateral. This simply is not the case. A loan secured by the value of a life insurance policy is like any other loan secured by property. Interest accrues on the loan and must be repaid. We therefore believe that changes in the present-law treatment of loans and distributions are not warranted.

We recognize that the Subcommittee's concern stems from advertisements which have highlighted the cash value of life insurance policies and the right of the policyowner to borrow against a policy. However, we would emphasize that a significant gap exists between what has been advertised and what policyholders actually do. The NALC and the LIC strongly oppose any efforts to change the tax rules with respect to life insurance policies, at least until it is shown that a specific problem exists because of these rules.

STATEMENT OF EDWARD E. PHILLIPS, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, THE NEW ENGLAND (NEW ENGLAND MUTUAL LIFE INSURANCE COMPANY)

Mr. Chairman and Members of the Subcommittee, we appreciate the opportunity to present the views of The New England on the very important subject of the appropriate tax treatment of life insurance products generally, and specifically, the use of single premium policies marketed as investments. It is our hope that the Subcommittee carefully will examine the record of these hearings both as to the relevant facts regarding life insurance product development and sales, and the structure of and rationale for the current tax law treatment of life insurance contracts.

Focus of the Hearings

In the press release announcing these hearings, Chairman Rangel expressed the Subcommittee's concern about whether the present law statutory definition of life insurance is sufficiently tight so as to curtail the purchase of single premium life insurance principally as an investment.

Additionally, it was announced the Subcommittee would explore the appropriateness of proposals to limit the use of life insurance as an investment vehicle without discouraging the purchase of life insurance as a means to provide death benefits for dependents.

Traditional Insurance Products Are Not The Problem

At the outset, we, at The New England, would emphasize the difference between the problem alluded to in the hearing announcement and the vast majority of non-abusive, traditional life insurance contracts which serve important and legitimate individual, family, small business and corporate insurance needs. It is our strongly held view, based upon marketplace experience and product development, that the orientation of the typical insurance consumer and the design of traditional contracts for that consumer is driven first and foremost by insurance considerations, not short-term investment strategies.

To be sure, the investment feature of permanent insurance and its related tax advantage - inside buildup - is an integral part of the majority of life insurance contracts sold. Congress understood the relationship of cash values to permanent insurance in 1984 when it adopted rules establishing that certain minimum ratios be maintained between amounts paid in to an insurance contract and amounts of insurance risk related to those payments in order to qualify a product as life insurance for Federal income tax purposes. At that time, Congress indicated that the rationale for requiring these minimum ratios was to de-emphasize investment-oriented contracts by permitting approximately no more in cash values in these newer contracts than that which was available under traditional level payment plans.

The accumulation of cash value built into the contract provides a systematic means by which adequate amounts of permanent life insurance is made affordable and accessible. To meet the real, long term protection needs of an individual, often a sole family wage earner, requires a level premium plan. Term insurance solves part of the mortality problem for part of the time the risk is faced, but costs typically rise each year. Permanent insurance makes the cost of such valuable risk protection more manageable over longer periods of time for the 40 million American households owning cash value insurance. The tax advantages conferred on cash value life insurance have been an enduring feature of the tax system precisely because this benefit contributes greatly toward encouraging the purchase of affordable risk protection. The benefits of this tax policy have been considered substantial in their own right: the encouragement of private saving, the placing of financial security primarily in the private sector rather than the public sector, the encouragement of capital formation through long-term investments held by life insurance companies, and the contribution made toward income security in retirement.

For businesses, especially small businesses, the leveling effect of cash value life insurance makes costs predictable and reasonable. Further, we would point out that there has been longstanding tax law acceptance of the utlization of permanent life contracts to provide key man insurance and other forms of corporate owned life insurance to meet the reasonable needs of a business. This is particularly true for small and family-owned businesses. As the Third Circuit stated in the oft-cited Emeloid case:

> "What corporate purpose could be considered more essential than key man insurance? The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself against the loss of two of its most vital assets - managerial skill and experience."
> Emeloid v. Commissioner, 189 F.2d 230 (3rd Cir., 1951).

Given that over the long term permanent whole life insurance is a cost efficient means of purchasing insurance protection, it should not be surprising that the tax law has traditionally sanctioned cash value insurance as a means of accomplishing what is admittedly a proper business purpose.

Broad-Based Ownership Validates Public Policy Underlying Life Insurance Tax Rules

Since 1913, Congress has periodically considered the appropriate tax treatment of permanent life insurance; at each juncture the basic policy supported by Federal income tax rules governing life insurance contracts has been preserved. This is true, despite the fact that those periodic examinations occurred in all manner of different tax, economic and product environments.

The basic reason for this continuity in policy, for the past 75 years and continuing today, is not simply because it always has been so, but out of a recognition that there is enormous and widely accepted societal value supporting the tax expenditure for permanent insurance. That value is not intangible; it can be measured.

The Government has available to it a vast array of data which we believe supports this contention. Insurance ownership today is broad based, typically insurance-risk oriented and not purchsed chiefly as an investment or some kind of tax shelter. For this reason, The New England welcomes an open-minded, periodic Congressional re-examination of this important public policy. Such a review, upon sober reflection of the facts in our opinion should not imperil the basic present law Federal tax scheme governing traditional permanent life insurance contracts.

Evolution of Statutory Limitations on Investment Uses of Life Insurance

A study of the history of the taxation of life insurance contracts reveals that Congressional and Treasury Department consideration of the tax benefits associated with permanent life insurance has been evolutionary. The pattern that emerges in legislation following intermittent examinations has been one of consistent acceptance of the historic tax treatment provided permanent life insurance, while, at the same time, dealing specifically with emerging financial uses of life insurance that do not comport with the long-standing tax policies encouraging the ownership of individual and business insurance for death protection. Past legislation has taken the approach of precisely attacking the "inappropriate" financial use while preserving the underlying fundamental tax scheme favorable to the traditional product. This was the pattern in the 1942 Act, the 1954 tax law, the 1964 Act and the 1982 and 1984 Acts. The New England strongly urges the Subcommittee, the Congress and the Administration to continue to follow this evolutionary approach. It has served public policy well.

We appreciate your obligation to review the relevance of public policy from time to time. We are not ignorant of the spate of investment and tax-oriented insurance product advertising by some insurers and non-insurance companies that followed passage of fundamental tax reform in 1986. Much of that advertising has emphasized the investment features of certain insurance products such as single premium life contracts, with little or no discussion of the real cost of insurance or the relevance of the investment performance to funding long term insurance coverage.

It may well be that the Subcommittee forms an opinion after these hearings that there are products evolving in the life insurance marketplace today that purport to offer financial or investment opportunities not consonant with the basic thrust of public policy conferring otherwise defensible tax benefits on permanent life insurance. In deliberating whatever response may be appropriate to the Subcommittee's findings, The New England, from a legislative process standpoint, urges the Subcommittee, and ultimately the full Committee, to adhere to the evolutionary approach of proscribing only those identified abuses inconsistent with current law tax treatment of life insurance products. Specifically, we urge you not to develop reforms with an overly broad reach that engulf traditional, non-abusive contracts, i.e., life insurance products whose uses have not been shown to offer financial returns inconsistent with the primary objective of insurance protection.

In fact, we believe that proposed reforms such as H. R. 3441, introduced by Congressmen Stark and Gradison, do just that and actually may run counter to the avowed policy of limiting investment utilization of life insurance without discouraging its purchase to provide death benefits.

H. R. 3441 Casts Too Wide a Net

H. R. 3441 would tax, to the extent of gain in the contract, all pre-death withdrawals from a life insurance contract, including loans and withdrawals from traditional ordinary whole life contracts sold many years earlier. This proposal would apply regardless of whether the product was a single premium contract or an ordinary whole life contract. It would apply to any insurance contract whether the cash value to death benefit ratio under the policy was very low or was the absolute maximum permitted under the Internal Revenue Code. In this regard, it represents a complete departure from past Congressional practice of clearly identifying the "financial use" abuse of the product, and then carefully pruning the diseased limb while preserving the policy trunk.

H. R. 3441 is not an appropriate response to the perceived abuse of excessive investment orientation of a new generation of life insurance contracts; rather, it adopts a least common denominator approach to tax-favored investments apparently based on the faulty assumption that all such investments are indistinguishable, serve equivalent purposes and/or have relatively equal inherent societal and public policy values. The New England urges the Subcommittee to reject this approach, to make and retain public policy distinctions that serve the interests of society, and refocus legislative responses where necessary to the evolutionary pattern of limiting those investment or financial uses of life insurance incongruous with fundamental insurance protection goals favored by the tax law.

Investment v. Insurance: Targeted Reform

At the core of the current debate over the appropriateness of Federal income tax policy regarding life insurance contracts is the concern that investment-oriented life insurance products are attracting investors who have no intention of holding life insurance principally for death benefit protection. There is great concern both in government and in the industry itself that life insurance is being marketed as a tax shelter. Both government and the majority of life insurance companies are alarmed by the apparent exploitation of the tax-free growth of life insurance inside buildup. In response to this exploitation, much of which is accomplished by means of misleading advertising and marketing practices that raise a host of legal questions outside the tax law area, we, at The New England, urge this Subcommittee to avoid an overreaching approach. Instead, we believe a targeted rifle-shot, if given a chance, will demonstrate effective reform and limit the tax benefits associated with permanent life insurance to those contracts purchased primarily for insuring against the risk of death and the provision of long-term savings.

The New England supports the proposed Amount Paid-In Limitation advanced by the National Association of Life Underwriters (NALU) as an appropriate response to the criticisms that there is too much investment orientation in certain contracts that otherwise meet the tax definition of life insurance under section 7702 of the Code. We support the NALU proposal because it would return the orientation of tax-qualified contracts to insurance risk and would limit increases in a policy's cash values in the early years of the contract to a level more commensurate with traditional products that have enjoyed (without abuse) the benefit of tax-free buildup.

The NALU proposal would amend the tax definition of life insurance to increase the true insurance risk in policies which are to qualify as life insurance under the present IRC sec. 7702 definition of life insurance. The Subcommittee will receive a very thorough analysis illustrating the Amount Paid-In Limitation by NALU. We will not reiterate the technical details here. There are, however, several salient points about the NALU proposal that we believe bear emphasis.

First, the Amount Paid-In Limitation if adopted would increase the required insurance risk in a tax-qualified contract by approximately 500 percent in its first 5 years.

Second, the proposal would result in a significant increase in the initial face amount of life insurance coverage that must be purchased with the same amount of premium. This will result in greater underwriting risk for the insurer, which itself is indicative of the thrust of the proposal -- to ensure that signficant current risk protection is being purchased by contributions to the contract.

Third, the proposal contains anti-abuse rules which for tax purposes prevent manipulation of the limitation by back-loading or otherwise understating costs of insurance protection during the limitation period, and by preventing lapses of contracts to paid-up insurance during the holding period from qualifying as life insurance contracts under the tax law.

If the Subcommittee believes the problem that some life insurance contracts are being designed and sold as a competitive and high-yielding investment contract, sold to individuals not interested in insurance protection and who do not consider such consumed insurance protection as a yield from the contract, then the NALU proposal precisely attacks that problem. The principal thing the NALU proposal does not accomplish is the complete abandonment of existing tax policy for most non-abusive life insurance contracts. It does not visit punishment on traditional insurance policyholders who have purchased insurance for those purposes for which existing tax treatment was designed.

The NALU proposal is consistent with the evolutionary approach of refining the Federal income tax treatment of life insurance contracts to ensure that such treatment, in fact, continues to serve a valid public policy.

Conclusion

The New England believes it is appropriate that Congress re-examine Federal tax policy affecting permanent life insurance contracts. We believe that the compelling arguments that have generated longstanding public acceptance of the tax expenditure for permanent life insurance are as forceful and relevant today as at any time in the history of our Federal tax system.

The New England also supports the judicious and reasoned pattern of evolving Federal tax policy governing the tax treatment of life insurance contracts. We believe that a study of the history of legislation affecting the taxation of life insurance contracts shows that Congress has consistently re-affirmed the fundamental soundness of these core Federal tax rules, while addressing various inappropriate financial uses of life insurance contracts that have emerged occasionally over the years. The rapidly changing financial marketplace and recent fundamental tax reform have brought us to one of those periodic threshholds of policy examination. We urge Congress once again to examine the facts, to make the value judgments that distinguish the role of life insurance and validate its Federal tax policy, and then to consider legislative reforms that target limitations to those types of contracts considered inconsistent or inappropriate relative to that tax policy.

Finally, The New England urges Congress to give serious consideration to the Amount Paid-In Limitation proposal advanced by the National Association of Life Underwriters. It is a serious and credible proposal. It targets reform where reform is needed, without undermining the tax rules affecting traditional life insurance contracts which are not considered abusive or investment-oriented. It is a proposal that is worthy of enactment, and we believe that it will result in substantial and effective reform.

THE NORTHWESTERN MUTUAL LIFE INSURANCE COMPANY
WRITTEN STATEMENT IN LIEU OF PERSONAL APPEARANCE
PUBLIC HEARING ON INVESTMENT USES OF LIFE INSURANCE

Subcommittee on Select Revenue Measures
Committee on Ways and Means
U. S. House of Representatives

The following is the written statement of The Northwestern Mutual Life Insurance Company ("Northwestern Mutual") on the issues discussed at the public hearing held on March 15, 1988, relating to the investment uses of life insurance.

Northwestern Mutual is a mutual life insurance company specializing in individual life and disability insurance and annuity products. Northwestern Mutual was founded in 1857 and is the tenth largest life insurance company in the United States. Northwestern Mutual is generally regarded in the life insurance industry as providing low net cost, permanent life insurance protection.

Permanent life insurance serves a valuable social purpose in providing both protection against death and a source of long-term capital formation for the economy. Permanent insurance permits the insured to spread over his or her lifetime the cost of lifetime protection, which otherwise would become very expensive as the insured gets older -- precisely when he or she is most at risk. It is for this very reason, sharply escalating costs at older ages, that most term policyholders drop their term coverage before they die. The vast majority of term life insurance never pays a death benefit. Thus, Congress was right to reaffirm, less than two years ago, the long-standing rules for taxing permanent life insurance.

However, there clearly is a problem with current law. The problem is the promotion and purchase of single premium (and other cash rich) life insurance as a tax-sheltered investment vehicle. Therefore, we urge Congress to act to limit the use of single premium life insurance as an investment vehicle without discouraging the purchase of permanent life insurance as an affordable means to provide death benefits to dependents.

Northwestern Mutual strongly supports the legislative proposal sponsored by the National Association of Life Underwriters ("NALU") and the American Association of Life Underwriters ("AALU") that would tighten the definition of "life insurance" for federal income tax purposes by limiting the amount that can be paid into a life insurance contract during the first five policy years. We believe that this proposal is the most appropriate and effective means of preventing the use of single premium life insurance as a tax sheltered investment.

The adoption of a "single premium" standard for the definition of "life insurance" was considered appropriate in 1984 when section 7702 was enacted because it relied on traditional life insurance concepts. The problem with single premium life insurance resulted from changes in the investment environment created by the 1984 and 1986 tax laws which Congress could not anticipate and which made single premium life insurance more appealing as an investment product. Following enactment of the 1986 Tax Reform Act, the investment aspects of single premium life insurance were heavily promoted and sometimes misrepresented in the financial press and in advertisements. As a result, sales of single premium life products increased from $3.5 billion of premium for the 1984-1985 two year period to a total of $14.4 billion of premium for the period 1986-1987.

The marketing practices used to sell single premium life to predominately older, high income individuals have been well documented. For example, a study by the Life Insurance Marketing and Research Association contained in the October, 1987 GAO report on the "Taxation of Single Premium Life Insurance" shows that nearly 70% of all single premium life insurance premiums are paid by individuals over 50 years of age. Moreover, it appears that the funds flowing into single premium life insurance have been diverted from other investment opportunities, since periodic premium life insurance sales have continued to show steady growth. It is too late to argue that a problem does not exist with single premium life insurance as some in our industry have done. We believe that the long-term interests of the country and the life insurance industry will be best served by the industry and Congress working together to address single premium life insurance abuses and, at the same time, to correct existing deficiencies in the computational rules under section 7702.

We suggest that any legislative solution to the single premium life problem should be judged by certain criteria. First, it should not overreach; in other words, it should be limited to single premium (and other cash rich) life insurance contracts. Second, it should be effective to stop the abuses of single premium life insurance. Third, it should not discriminate between product types such as universal life, traditional whole life insurance and variable life insurance. Fourth, it should be prospective only.

H.R. 3441, which would change the distribution rules on all life insurance, clearly does not meet these criteria. The bill is overly broad because it would adversely affect all life insurance products and would change long-standing rules regarding recovery of basis and taxation of policy loans. In particular, the taxation of policy loans is excessive because the phase-out of the personal interest deduction has already significantly reduced the use of policy loans for reasons other than hardship. The bill would have a chilling effect on the sale of all permanent life insurance products regardless of whether they were sold for investment purposes and would even apply to subsequent transactions under policies in force on the effective date of the legislation. Finally, the bill is not as effective as the NALU/AALU proposal because it does not narrowly target the single premium life problem. The distribution rules proposed in H.R. 3441 will do little or nothing to discourage single premium life sales in its primary market -- ages 55 to 60.

The NALU/AALU proposal, on the other hand, satisfies all four criteria. It would prevent the purchase of life insurance primarily as an investment vehicle by requiring higher initial levels of risk protection and multiple premium payments in order to purchase paid-up life insurance. Life insurance would not be attractive to individuals unless they had a bona fide need for insurance protection and were willing to pay for it.

The NALU/AALU proposal has been criticized at these hearings as too harsh, not effective, harmful to long-term savings and hostile to stockbrokers. None of these criticisms has merit.

The NALU/AALU proposal would not put single premium life insurance companies out of business. It would simply require more death protection in the contract during the first five years and restrict the amount of cash per dollar of coverage. Many investors who were not interested in life insurance protection would return to purchasing the traditional long-term saving vehicles offered by life insurance companies--annuities.

We also believe that the proposal would be effective. A five year limitation is adequate to prevent investment sales of life insurance. Perhaps the criticism that the NALU/AALU proposal "goes too far" is the best indication of its effectiveness. The industry desperately needs stability in life insurance taxation and we know that, if we are to have stability, we must have an effective test for single premium life insurance. We are willing to work with Congress to obtain this goal.

The proposal will also not harm long-term savings. Annuities are the traditional long-term savings product sold by the life insurance industry and are taxed less favorably than life insurance for that reason.

Congress never intended that single premium life insurance be used primarily as a savings vehicle. In fact, the abuse we are addressing is that single premium life insurance has been marketed as an annuity which is taxed like life insurance. Simply stated, the cost of required insurance protection under single premium life is less than the tax cost under the annuity rules, so investors are better off buying the single premium life contract.

Finally, any assertion that the NALU and the AALU are attempting to drive stockbrokers out of the life insurance business is patently untrue. The issue is what is being sold, not by whom, and we believe that no life insurance products should be sold without regard to underwriting or risk classification. In any event, life insurance agents are also major sellers of single premium life insurance and stand to lose as much as stockbrokers by a restriction on single premium life insurance. Furthermore, under the NALU/AALU proposal, both life insurance agents and stockbrokers can continue to sell single premium life insurance, albeit with more coverage, and will be benefited by a clarification of the tax treatment of the product.

Some in the industry are promoting a so-called combination approach to the single premium life problem. This approach would define cash rich life insurance contracts for the limited purpose of changing the tax rules relating to distributions from such contracts. We believe that the NALU/AALU proposal disqualifying those contracts from life insurance treatment entirely would be far more effective in eliminating the sale of cash rich life insurance as a tax-sheltered investment.

In conclusion, Northwestern Mutual strongly believes that any solution to the single premium life problem must:

(i) not overreach and adversely affect the vast majority of life insurance that is purchased primarily for protection and not as a tax sheltered investment; and

(ii) at the same time be effective in limiting the marketing and sale of insurance products as tax shelters.

We believe that the NALU/AALU proposal accomplishes both of these objectives and recommend that the proposal be enacted.

Respectfully submitted,

THE NORTHWESTERN MUTUAL LIFE
INSURANCE COMPANY

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March 11, 1988

The Honorable Charles B. Rangel, Chairman
Subcommittee on Select Revenue Measures
House of Representatives
2330 Rayburn House Office Building
Washington, D. C. 20515

Dear Representative Rangel:

SUBJECT: HR 3441

Public Service Company of Colorado is committed to providing post-retirement benefits to its employees which, according to estimates, will eventually total hundreds of millions of dollars. In 1984 and 1985, in order to provide funding for such deferred liabilities, Public Service Company purchased life insurance on approximately 2,400 of its longer-term employees naming Public Service Company as beneficiary. If allowed to succeed, this funding effort will help to control the growth of future electric and gas rates in Public Service Company's service territory while also providing security to its employees that promises of future benefits will be honored.

Because of the ineffectiveness of its grandfathering provisions, HR 3441 threatens the viability of Public Service Company's funding plans. As presently proposed, HR 3441, if passed, will:

1) Revise the contractual and legal terms under which Public Service Company purchased its life insurance policies -- three years after the fact;

2) Cause Public Service Company to collapse its insurance policies, since they would no longer provide the funding originally intended or needed; and

3) Seriously set back Public Service Company's attempts to pre-fund its employee-based deferred liabilities, thereby imposing a greater burden on future electric and gas customers who must bear the cost instead.

Absent effective grandfathering provisions, Public Service Company of Colorado urges you to oppose HR 3441 should it come before you for consideration. HR 3441 is detrimental to Public Service Company, to its employees, and to its customers.

Very truly yours,

Dan R. McNellis

Dan R. McNellis
Vice President
Governmental and
Environmental Affairs

March 15, 1988

STATEMENT OF THE STOCK COMPANY INFORMATION GROUP FOR THE RECORD OF THE HEARING BY THE SUBCOMMITTEE ON SELECT REVENUE MEASURES CONCERNING THE "INVESTMENT USES" OF LIFE INSURANCE

The Stock Company Information Group (the "SIG") submits this statement for the record of the March 15, 1988 hearing by the Subcommittee on Select Revenue Measures concerning the "investment uses of life insurance." The SIG is a coalition of 27 investor-owned life insurance companies which was organized in 1981 to monitor tax legislative developments and to convey the views of its membership on life insurance tax issues to the various insurance trade associations and to the Government. Taking into account its members' affiliated companies, the SIG includes a majority of the 50 largest life insurance companies in the United States. The SIG has been privileged to work closely with this Subcommittee, the Committee on Ways and Means, and their staffs in connection with the development of the insurance tax provisions of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), the Deficit Reduction Act of 1984 (the "1984 Act"), the Tax Reform Act of 1986 (the "1986 Act"), and the Revenue Act of 1987. A list of the SIG member companies appears at the end of this statement.

The focus of this hearing, according to the Subcommittee's notice, is the propriety of the income tax rules for life insurance policies in view of the current uses of such policies, particularly "single-premium policies and other policies marketed primarily as investment vehicles". The hearing notice, however, appropriately expresses the concern that any changes made to those rules should not have the effect of "discouraging the purchase of life insurance as a means to provide death benefits to dependents." The members of the SIG fully share this concern, and to that end we offer the following views. These views reflect, in particular, the SIG's commitment to the effective functioning of the statutory definition of a "life insurance contract," contained in section 7702 of the Internal Revenue Code, on which the SIG worked intensively throughout its evolution under TEFRA, the 1984 Act, and the 1986 Act.

As explained in what follows, the SIG recommends that the section 7702 definition of life insurance not be changed in any respect. Further, the SIG believes that no other change should be made in the remaining tax rules respecting life insurance policies unless and until this Subcommittee satisfies itself that a specific problem exists because of those rules, and that a solution can be fashioned which directly addresses that problem without raising other, unnecessary difficulties. In this connection, we offer a number of observations about the nature of any such problem, along with the strengths and weaknesses of various proposals to change the law. In saying all of this, we would have the Subcommittee note that all SIG members are also members of the American Council of Life Insurance (the "ACLI"), and that we join in the ACLI's request, in its testimony before this Subcommittee, that a cooperative effort be made to resolve all concerns in a balanced fashion.

Statement of the "Problem"

The "problem" that is the subject of this hearing is far from clear to many people. The problem, in very general terms, presumably is that the tax law's rules are somehow being "abused" in their application to one or more classes of policies currently being sold. However, we question whether the existence or extent of any such abuse has been, or can be, established.

If the "abuse" is that "investment-oriented" uses of life insurance policies have, in the minds of some, proliferated after passage of the 1986 Act, we doubt that the available data can demonstrate this. Such uses presumably would focus on the "favorable" tax treatment of pre-death transactions employing certain policy features -- namely, borrowing against policy cash values on the sole security of the policy ("policy loans"), and withdrawals of cash values that do not terminate the policy ("partial withdrawals"). Specifically, these uses would rely on the fact that life insurance policy loans are debt proceeds which are not included in income for tax purposes, or on the rule of section 72(e)(5) of the Code which treats a partial withdrawal from a life insurance policy as not includible in income until the policyholder has recovered his or her payments for the policy. The latter rule, which has been in place for many decades, is sometimes referred to as one of "cost recovery first."

We do not think that the record can show a proliferation of such uses. To our knowledge, policy loan activity has not increased generally, nor has there been an acceleration in the numbers or amounts of policy loans under any class of policies. A recent survey collecting data on single premium life insurance policies, for example, shows loans on just 8.4 percent of those policies as of mid-1987, amounting to only 3.7 percent of the policies' aggregate cash values. (This survey, covering the single premium policies of companies that issued roughly three-quarters of all such policies in 1987, was conducted by the Committee of Life Insurers, which is also testifying at this hearing.) By way of comparison, according to the 1987 update of the Life Insurance Fact Book published by the ACLI, policy loans (through the end of 1986) accounted for about 5.8 percent of total life insurance industry assets (the amount of loans expressed as a percentage of cash values probably would be considerably higher). This, to us, does not demonstrate a pattern of enhanced or excessive borrowing against life insurance policy values; if anything, it tends to confirm the opposite. Similarly, there is no evidence of an increase in partial withdrawals.

We are aware, of course, that articles and advertisements published over the past year have touted the availability of such investment-oriented uses, particularly in the context of single premium life insurance policies. However, it strikes us as premature for legislation to be initiated solely on this account. Regardless of advertising and other unsolicited advice, policyholders ultimately may not take policy loans or partial withdrawals in greater amounts than they do today. Moreover, it is worth recalling that state law requires the loan feature to be included in a life insurance policy specifically to enable the policyholder to have access to his or her cash values, such as in a time of emergency or hardship, without necessitating the complete surrender of the policy. At minimum, it would seem to us that, in view of these points, any legislative action undertaken in this vein should closely and carefully target what is perceived to be the problem, leaving all other situations untouched.

Apart from the foregoing, some might argue that an "abuse" lies in an undue emphasis on the build-up of values internal to a life insurance policy -- the cash values or "inside build-up" -- which, if not withdrawn prior to death, is not taxed. As a general matter, nontaxation of the inside build-up of life insurance has been the policy of Congress since the inception of the modern income tax, a policy which Congress reaffirmed as recently as 1986. It is obviously of great importance to the life insurance industry and its tens of millions of policyholders. The governing statute here is section 7702 of the Code, which draws the line between policies with cash values that are recognized as life insurance for tax purposes, and those that are not treated as insurance policies but rather as investment vehicles in the eyes of the tax laws. Life insurance policies that meet section 7702's requirements are not taxed on their inside build-up (unless, again, the values are withdrawn prior to death), whereas those that fail its requirements are classed as investments and their gains are taxed currently as they emerge (these cannot be sold as insurance). The members of this Subcommittee are well aware of this, of course, since it was this Subcommittee that initially fashioned section 7702 in the course of considering the insurance-related provisions of the 1984 Act. Since we do not perceive anyone to be seriously contending that the presence of some build-up of values inside a life insurance policy makes that policy excessively investment oriented, the issue at most comes down to a line-drawing exercise such as that already engaged in by section 7702.

Technically, section 7702 erects its barriers against excessive investment orientation by limiting the cash values or premiums under a life insurance policy relative to the amount of the policy's death benefit. It does this by mandating that the policy, if it is to be treated as one of life insurance for tax purposes, comply with one of two sets of requirements: (1) a "cash value accumulation test," or (2) a combination of "guideline premium" and "cash value corridor" requirements. The cash value accumulation test provides, in essence, that the policy's cash value at any time cannot exceed the "net single premium" for its death benefit at that time (computed in accordance with certain assumptions prescribed in the statute). Stated in other words, this test stipulates that the cash value at any policy duration must not be greater than the single premium which (net of expenses) will permanently purchase the policy's death benefit. The guideline premium test, on the other hand, focuses on the premiums paid for a policy, requiring that those premiums not exceed the greater of the single premium, or of the cumulation of level annual premiums, needed to purchase the death benefit. It further requires, by virtue of its related "corridor," that in no event may the policy's cash value exceed a specified percentage of its death benefit. The section 7702 tests studiously avoid regulating the price of insurance, however, by insisting on the use of guaranteed policy charges in determining the statutory limits.

Section 7702's requirements employ the single premium concept because, in the context of life insurance, it makes perfect sense to do so: life insurance premium, nonforfeiture value, and reserve calculations all proceed from that concept. For example, when the premium payments for an ordinary whole life insurance policy (under which level annual premiums are payable for life) are in default, then as required by state law, continuing death benefits are made available to the policyholder, computed on a single premium basis. These are sometimes called "nonforfeiture" benefits. Such benefits will equal, at the policyholder's option, either the permanent coverage that the policy's cash value will purchase when applied as a single premium ("reduced paid-up insurance"), or the higher amount of term coverage similarly purchased which may not last for the insured's remaining life ("extended term insurance"). Another instance of the use of the single premium concept is found in the so-called paid-up addition, which typically is an extra amount of permanent insurance purchased under a participating policy by applying a policy dividend as a single premium. Section 7702 also makes use of the single premium concept to avoid difficulties that would arise from the mandating of any minimum multiple-premium or "spread pay" requirement. Such difficulties, which would include the inability of a new policy to accept values exchanged from an older policy (such as under section 1035 of the Code) and the disqualification as life insurance of a policy placed on a nonforfeiture basis (as just described), are neatly precluded by the use of the single premium rule.

In view of these points, and in view of the subject matter of this hearing, it is of more than passing interest that this Subcommittee considered and rejected the use of a minimum spread pay requirement when it was framing section 7702 in the summer and fall of 1983. The original proposal for enactment of a comprehensive tax definition of life insurance suggested that former section 101(f) of the Code (enacted as part of TEFRA) be used as the new definition's blueprint, though with certain modifications. Section 101(f), which used guideline premium and corridor requirements and an alternative cash value test to limit the permitted investment orientation of a universal life insurance policy, employed the single premium concept just as section 7702 now does. A modification proposed in 1983 was to replace the single premium rule with a minimum 10-pay rule, i.e., a life insurance policy (to be so treated for tax purposes) could not have its guaranteed death benefit purchased with fewer than 10 equal, level premiums. The SIG strongly opposed any such modification, and in its statements to this Subcommittee urged that the single premium rule be preserved. This Subcommittee agreed, and Congress ultimately adopted section 7702 in its current form.

If the Subcommittee's entirely proper decision of 1983 were to be reworked today, introducing a minimum spread pay requirement, the problems previously identified would remain. Perhaps more to the point, any such change would take a class of life insurance policies -- policies (including single premium policies) which have death benefits substantially in excess of their current cash values and which therefore contain sizable insurance risk amounts -- and would call them "not insurance." Frankly, we see no purpose in this, and find the result totally unacceptable. We also think it self-defeating for Congress to go down this road, for all that it would accomplish is to redraw the allowable edge of investment orientation, and that in turn would become the new frontier for policy designs and sales and the inevitable next subject for congressional inquiry. Pursuing such a course, Congress would soon find itself sliding down the proverbial "slippery slope."

In the view of the SIG, the proper balance between the investment and insurance features of any life insurance policy -- more specifically, between the maximum cash value and the minimum insurance risk amount given the death benefit under the policy -- was struck by this Subcommittee when it fashioned the current section 7702 rules. In our view, this is true for low premium universal life policies, for limited-pay whole life policies, for single premium paid-up additions under whole life policies, for single premium insurance in general, and for coverage provided on a single premium basis under a nonforfeiture option. The main point is really quite simple: life insurance, properly understood and defined, can be purchased with one premium payment for life, or with level weekly premium payments for life, or with any form of payment in between. Premium mode is irrelevant.

Analysis of Proposals to Amend the Law

The Subcommittee's hearing notice indicated that the hearing would also explore whether various potential solutions to the "problem" would appropriately limit the uses of life insurance policies for "investment" purposes, and whether they would do so without discouraging the uses intended by Congress. We are aware of two basic approaches here. One approach would redraw the line of maximum investment orientation permitted for a life insurance policy under section 7702 (a "definitional" approach). The other basic approach would avoid taxing the inside build-up of a policy (by avoiding any change to section 7702) so long as that build-up remained "inside" the policy, but would include in income any pre-death distributions from the policy, and would even treat policy loans as such distributions (a "distributional" approach).

NALU Proposal. Perhaps the most prominent current proponent of a definitional approach is the National Association of Life Underwriters ("NALU"). NALU has suggested that the "problem" can be solved by introducing a spread pay requirement into the definition of life insurance. Specifically, the NALU proposal is to add to section 7702 a new (third) test which would require, for a policy to be treated as one of life insurance, that the policy's guaranteed death benefit be purchased no more rapidly than with 5 level, annual premiums (a "5-pay" rule). The NALU proposal would regulate the price of life insurance by imposing uniform charges to be taken into account in computing those 5 premiums.

The SIG strongly opposes any effort to amend section 7702, including the NALU proposal. For the reasons previously detailed, any such change would necessarily, but fruitlessly, classify legitimate life insurance policies as not life insurance. Thus, single premium and other less-than-5-pay policies could no longer be sold, obviously to the detriment of policyholders wishing to use such policies as a means of providing death benefits. We also would make these additional points about this proposal:

o Single premium life insurance, because of its mode, can and does deliver coverage more cheaply than other permanent policies -- and this is due to lower sales charges, not just time value of money. Thus, while selling commissions on typical annual premium whole life policies may fall in the range of 8-9 percent of the aggregate policy premiums (discounted to present value at 8 percent), those same commissions generally will amount to only 3-5 percent of a policy's single premium.

o As previously noted, adoption of a spread pay requirement in the definition of life insurance would prohibit (or at least inhibit) a policyholder from exchanging his or her policy for a better policy, and would tax currently the inside build-up of an annual premium policy placed under a nonforfeiture option within the spread pay period. The former effect runs contrary to the intent of Congress underlying section 1035; the latter clashes with the state law requirements mandating nonforfeiture benefits as continuing life insurance benefits.

o The NALU proposal, like any other effort to impose artificial charges on the section 7702 calculations, introduces the notion of Federal price regulation of limited payment life insurance. This is unprecedented and, in any event, totally out of place in the tax law.

o If the "problem" with which the Subcommittee is ultimately concerned relates to excessive borrowing or withdrawals, a definitional approach does not address this at all.

GAO Proposal. The General Accounting Office (the "GAO") has previously recommended consideration of a definitional change to address the "problem" of excessive policy loan activity. Specifically, under the GAO's proposal, section 7702 would be amended to apply its "cash value corridor" requirement (found in section 7702(d)) to death benefits *net* of any outstanding policy loans. Currently, that corridor requirement mandates that death benefits, unreduced by policy loans, be a certain percentage of cash values, though only in the case of policies qualifying as life insurance by meeting the guideline premium test.

The SIG also opposes this suggested change to section 7702 because, with due respect, the GAO's proposal is not well conceived and will not address the excessive borrowing "problem" the GAO has identified. State laws would still require policies to contain the policy loan feature. After enactment of a rule like the GAO's, it is conceivable that a life insurer might do nothing more than caution each policyholder that if borrowing occurs under his or her policy, that policy eventually may fail to be treated as life insurance for tax purposes unless the loan is repaid. The disqualification as life insurance most likely will occur in the policyholder's later life, and the resulting penalty -- current taxation of the prior and future inside build-up -- would be draconian in effect. One seriously wonders whether this would do more than merely confuse policyholders.

On the other hand, life insurers might anticipate borrowing, building into their policies the potential for increasing amounts at risk at later ages. Thus, policy provisions might mandate compliance with the net corridor, and the issuing insurers would strengthen their underwriting requirements and cost of insurance charges -- for everyone, without regard to borrowing. This would render the proposed rule meaningless as an impediment to borrowing. In short, under the GAO proposal, life insurance would become less desirable for all, with no effect on the "problem" that the GAO has perceived. Also, this proposal has not even attempted to take account of loans from third parties which are collateralized with a policy, and we doubt that it can.

H.R. 3441 and Related Proposals. A broad-based distributional approach is taken by H.R. 3441, the bill introduced last October by Congressman Stark and co-sponsored by Congressman Gradison. Under this bill, policy loans and partial withdrawals are included in income under a gain-out-first approach, reversing the cost recovery rule of current section 72(e)(5); assignments of policy values, with or without consideration, result in deemed distributions to the extent of the value assigned; and an additional "penalty" tax is levied on the amounts so included in income, with some exceptions. In short, rules similar to those applicable to annuity contracts under sections 72(e) and 72(q) of the Code are imposed on life insurance policies for the first time, and they are imposed on all policies, including pre-existing ones, without distinction. Only limited "grandfathering" of policies is proposed: premium payments through October 7, 1987, may be recovered using the rules being overturned.

A related, though far more circumscribed, distributional approach seems contemplated by several other proposals. An informal recommendation that we understand the Treasury made last fall apparently used many of the features of the Stark-Gradison bill, but applied them solely to policies that were paid up with fewer than 5 level premiums. To largely the same effect is a proposed "combined approach" ascribed to the Metropolitan Life Insurance Company; it is "combined" in that it weds a "definitional" element to what is basically a "distributional" approach. The ACLI, in its testimony before this Subcommittee, discusses the exploration of something similar. In the following comments, we will focus on H.R. 3441 as introduced, since it is the most broad and concrete formulation of a distributional approach that has yet been put forward.

H.R. 3441 endeavors to address the perceived "problem" of excessive borrowing or withdrawals by brushing aside section 72(e)'s cost recovery rule for all policies and all time. It seems to us that the cost recovery rule is not yet ready for such rushed and unceremonious burial. This rule has been in the law for decades, and embodies the theory (also evidenced in the open transaction doctrine and in other rules of the tax law) that taxable gain should not be presumed to exist until it is clearly established. One possible alternative to H.R. 3441's flat reversal of this rule would be its retention in cases where the reversal was not deemed essential, let alone prudent. If, for example, failure to meet some spread pay requirement could be used to identify cases where the cost recovery rule should be reversed, taking such an approach could better confine the scope of the solution to the problem at hand. The use of a spread pay requirement in this context would not be problematical as it is when used in the definition of life insurance. Also, before a gain-out-first rule is enacted to replace cost recovery, consideration should be given to the desirability of a "pro-rata" approach, which would aptly recognize that a dollar borrowed or withdrawn from a life insurance policy is no more traceable to the policy's inside build-up than to the policyholder's (after-tax) premium payments.

As an adjunct to displacement of the cost recovery rule, H.R. 3441 also sweeps life insurance policy loans into its net, equating them with other pre-death policy distributions. This is something of a sea change, however, and should at least be acknowledged as such. Policy loans historically have been viewed like other loans, which do not give rise to income. Why should a loan collateralized with a life insurance policy be treated as other than debt and subjected to income tax, while a loan collateralized with any other form of property (including appreciated property) is not so treated? Also, if some policy loans, or loans on some policies, must be treated like distributions for tax purposes, must all be so treated?

If, nonetheless, this Subcommittee were to conclude that there is a current problem with policy loans and withdrawals which is properly addressable by "distributional," gain-out-first means, then we would strongly note that H.R. 3441, as the embodiment of such means, needs refining.

First of all, it improperly applies its rules retroactively. Any legislation relating to the subject matter of this hearing should, at minimum, apply only to policies issued after a specified future date. To do otherwise would be most unfair to existing policyholders. Enacting any new rules with retroactive effect would also entail enormous administrative complexity for life insurers, particularly in the case of policies still in premium paying mode. In many such cases, records that would be needed to make the required calculations either do not exist or exist in a form that is not practicably accessible. Furthermore, since payments on such policies necessarily would "straddle" the effective date of the new rules, some means would need to be devised to allocate policy charges between "old" and "new" segments of cash values. We also think it noteworthy that the bill's proposed effective date for policy loans, in particular, raises far more questions than it answers. By way of illustration, it requires one to know when a policy loan is "made," and when it is "revised," "extended," or "renewed." To our knowledge, no one knows the answers.

A second major problem area in H.R. 3441 relates to its treatment of policy assignments, whether with or without consideration. Assignments with consideration are automatically treated as loans (and subjected to tax), disregarding the role played by assignments in the case of life insurance policies. For example, assignments are used to effect exchanges under section 1035 of the Code, and also to create employee benefit arrangements which otherwise bear current taxation. These evidently should not trigger tax.

And perhaps even more fraught with difficulties is the fact that assignments of policies to third parties, as collateral or for other reasons, present insurers with little information and even less control. Application of the bill's assignment rule in such cases necessarily presents insurers with severe administrative problems, and guidance clearly is needed. In particular, insurers will need to know how to deal with information reporting requirements attendant to treating these assignments as distributions.

Third, H.R. 3441 fails to take account of the role played by life insurance policy loans and cash value charges in providing continuing insurance benefits. Current section 72(e)(4)(B) of the Code, which the bill would keep in place, provides that in the case of annuities, dividends retained by an insurer as additional premium for a contract are not treated as distributions. In essence, this rule assures the sensible result that, when amounts are retained or "recycled" within a policy to enable the continued provision of insurance benefits, such amounts are not treated as distributed and thereby subjected to taxation. Rather, they are viewed, correctly, as remaining within the "inside build-up." We think it evident that this rule should be clarified and expanded such that, at minimum, loans made to pay premiums, partial surrenders to pay premiums, loans to cover interest on premium loans or pre-existing loans, charges for "qualified additional benefits" as defined in section 7702, and charges for certain other additional benefits (including the provision of long-term or convalescent care) should not be considered distributions from a life insurance policy.

Fourth, the bill fails to consider the desirability of retaining current law in the case of loans and distributions up to a specified amount, or made for specified extraordinary or hardship purposes (such as to cover medical or educational expenses or to purchase a residence). We would urge the provision of such a rule, particularly in light of the unusual step taken by the bill in subjecting debt proceeds (from policy loans and third party loans) to current taxation as a general matter.

Fifth, the bill leaves totally unclear the treatment of policy exchanges involving loans, repayments of policy loans, and releases of assignments. At minimum in this regard, the bill should clarify that, as under current law, policy exchanges involving loans entail the continuation of indebtedness (insofar as it is not reduced) rather than its discharge and renewal, and that loan repayments and assignment releases at least increase the policyholder's "investment in the contract" for section 72 purposes.

Finally, the bill assumes that a penalty tax must apply in order to deter impermissible investment uses. This disregards the fact, however, that life insurance policyholders incur substantial costs for the issuance and maintenance of their policies. The SIG strongly believes that no penalty tax on life insurance policy distributions (and loans) is justifiable, and urges its omission from any proposal endorsed by this Subcommittee.

Conclusion

The membership of the SIG appreciates this opporunity to offer its views to the Subcommittee. In sum, we see no need to change the current tax rules respecting life insurance policy taxation. If you conclude otherwise, then we request the opportunity to work with you and with members of your staffs in resolving, in as precise a manner as possible, whatever problems that you decide legislation is now needed to address.

Respectfully submitted,

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By:
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On behalf of the Stock Company
Information Group

MEMBERS OF THE STOCK COMPANY INFORMATION GROUP

Aetna Life & Casualty Company
Allstate Life Insurance Company
American General Corporation
Business Men's Assurance Company of America
Capital Holding Corporation
CIGNA Corporation
CNA Insurance Company
Federal Kemper Life Assurance Company
First Capital Life Insurance Company
Franklin Life Insurance Company
Hartford Life Insurance Company
ICH Corporation
IDS Life Insurance Company
Integon Life Insurance Corporation
Jefferson-Pilot Life Insurance Company
Liberty Life Insurance Company
Life Insurance Company of Georgia
Life Insurance Company of Virginia
Lincoln National Life Insurance Company
Monarch Capital Corporation
Paul Revere Life Insurance Company
Provident Life and Accident Insurance Company
Torchmark Corporation
Transamerica Occidental Life Insurance Company
Travelers Insurance Company
UNUM Corporation
Washington National Insurance Company

March 29, 1988

STATEMENT OF
SUN LIFE ASSURANCE COMPANY OF CANADA (U.S.)
AND
MASSACHUSETTS FINANCIAL SERVICES
REGARDING
THE TAXATION OF LIFE INSURANCE
TO
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
MARCH 15, 1988

This statement is submitted by Sun Life Assurance Company of Canada (U.S.) ("Sun Life"), a wholly-owned subsidiary of Sun Life Assurance Company of Canada, and by Massachusetts Financial Services ("MFS"), a wholly-owned subsidiary of Sun Life.[1] Sun Life is a leading domestic issuer of a wide variety of life insurance contracts, including single premium life contracts. MFS is the wholesale distributor of Sun Life's policies to stock brokerage firms and insurance broker-dealers. This statement puts forth a proposal that is tailored to meet concerns regarding the tax treatment of insurance contracts, without undermining unnecessarily the basic tax policy to encourage the purchase of life insurance for death protection and long-term retirement savings.

As an initial matter, Sun Life wishes to express its support for the views expressed by the Committee of Life Insurers opposing proposals to modify the income tax treatment of life insurance contracts. The long standing policy of encouraging individuals to provide for their dependents in the event of death is unquestionably a sound one. Moreover, the 1984 and 1986 changes narrowing the tax definition of life insurance responded fully to the perceived problem of overly investment-oriented insurance products. These changes also reaffirmed Congress's continuing support for tax incentives to promote the acquisition of life insurance protection by individuals. There is no indication that the use of life insurance for other than its intended purposes is widespread: notwithstanding the impression created by improvident advertisements, a recent study conducted by the Committee of Life Insurers shows that policyholders have borrowed only 3.7% of accumulated cash values. In short, the fundamentals of life insurance taxation are sound, and no change is warranted.

If the Subcommittee nevertheless determines that there is a need for legislative action, Sun Life believes that the following features form the framework for a reasonable response to concerns raised about the tax treatment of life insurance:

1. Distributional approach

There is no reason to change the Section 7702 definition regarding what contracts qualify as "life insurance" for tax purposes. Congress enacted this definition in

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1/ Sun Life and MFS are referred to collectively herein as "Sun Life."

1984 (based on a 1982 provision in Section 101) and tightened the definition in 1986; at this point the definition demonstrably limits the enjoyment of tax-free buildup to contracts with a significant life insurance element.

Sun Life accordingly believes that the proposal submitted by the National Association of Life Underwriters to limit the definition of life insurance to so-called "5 pay" policies is flawed. As Deputy Assistant Treasury Secretary for Tax Policy Dennis Ross noted in his testimony, redefining life insurance to deny tax benefits to single premium insurance products constitutes a fundamental change in Congress' prior approach to life insurance taxation. More important, a purely definitional approach constitutes an unnecessarily broad-based attack on single premium policies. As noted below, the purported problem is not single premium policies; the purported problem is the premature withdrawal of cash values from single premium policies. The NALU proposal would deprive consumers of a choice of insurance products, and would apply different tax rules to life insurance policies based solely on premium structure, rather than possible use as investment vehicles. Moreover, depriving all single premium policies of tax benefits through a definitional approach would force consumers to accept the higher administrative costs associated with the periodic billing and account maintenance incumbent in multiple premium policies.

What has raised this Subcommittee's concern is the potential for manipulation of the tax benefits accorded insurance contracts through the policyholder's receipt of funds accumulated under the contract without adverse tax consequences. It is the current tax-free enjoyment of the buildup, not its accumulation, that should be the focus of these deliberations.

As observed by Deputy Assistant Secretary Ross, if the Subcommittee believes that additional protections are necessary, a "distributional" approach that taxes certain withdrawals and loans from life policies, judiciously applied, provides a more reasoned basis for preventing the use of insurance tax provisions as an unwarranted tax shelter. By taxing certain distributions, new legislation could limit the potential for abuse, while continuing to provide the traditional tax treatment for single premium contracts that provide legitimate insurance.

2. Apply the distributional rules only to single premium policies

The indiscriminate application of new distribution taxation rules to all life insurance policies is inappropriate. This Subcommittee is conducting these hearings because it is concerned about the use of life insurance as a flexible investment vehicle. That concern arises out of the view that life insurance should be used to provide death protection and long-term retirement savings. Multiple premium life insurance -- under which the taxpayer pays premiums over a number of years -- has long been recognized as a cornerstone of an effective program for death protection and retirement savings. The requirement that the policyholder commit to pay premiums in the future -- regardless of the investment environment or economic conditions existing at that time -- precludes the use of the policy as a manipulable short-term investment vehicle. As a result, the justification for imposing restrictive rules on distributions is not present in the multiple premium context.

H.R. 3441 would deprive all types of insurance policies (including multiple premium policies) of traditional tax benefits upon distributions. This bill unnecessarily would discourage the purchase of insurance contracts that do not offer the potential for investment-oriented abuse. Indeed, with the exception of H.R. 3441, all of the legislative proposals currently under consideration recognize that multiple premium policies generally are not used as short-term investment products, and that the imposition of taxes on pre-death distributions from such policies is not warranted.

Like a multiple premium policy, single premium life insurance gives meaningful death protection (as required by the Section 7702 guidelines) while providing a source of retirement funds. Investment manipulation occurs, if at all, only when the policyholder disturbs the long-term nature of the policy by withdrawing the cash value after a short period of time, either through a loan or a partial withdrawal. Because this withdrawal may be inconsistent with the purpose and goals of the life insurance product, it may make sense to tax the withdrawal from a single premium policy.

3. Distribution restrictions eliminated after fifteen years

Distribution taxation is unnecessary where the potential for investment flexibility and manipulation does not exist, or is not the motivating factor in an insurance purchase. For example, the single premium policyholder who is willing to forego access to his premium dollars for a long period is not motivated by investment decisions, but rather is seeking effective insurance and retirement planning. In recognition of this, the 1986 Tax Reform Act definition of life insurance contained in Section 7702 affects distributions only during the first fifteen years after a life insurance contract is issued. This fifteen year "safe-harbor" provision reflects the assumption that, even in the case of single premium distributions, a policy held for fifteen years is more likely to involve insurance and long-term savings planning, rather than short-term investment and enjoyment of tax free income benefits.

Similarly, any new distribution tax rule is justifiable only for some period following the initial policy purchase. To recognize the legitimate role of single premium policies in long-term insurance planning, restrictions on distributions should be lifted fifteen years after a policyholder has made final payment on a single premium policy. Further, to facilitate the use of life insurance as a retirement savings and planning vehicle, this fifteen-year waiting period should be shortened (say, to five years) for individuals who have reached retirement age.

4. Medical, disability, educational and financial hardship exceptions

The tax on distributions should contain exemptions to cover non-investment-oriented extraordinary expenses. Distributions and loans from the tax-free "inside buildup" of insurance contracts do not, when used in these contexts, run counter to the policies supporting favorable tax treatment of life insurance.

Sun Life has found that the perception of policyholders regarding the liquidity of their funds is important in the consumers' decision to devote limited family resources to insurance. Our experience is that although policyholders do not often take advantage of loan and other distribution provisions, the flexibility to gain access to the funds in an emergency is important. If put to a choice between having the flexibility to meet emergency expenses and locking income into an illiquid insurance contract, the average consumer will not buy insurance. A tax on policyholder distributions without any financial hardship provision exception therefore will have a disproportionate impact in discouraging the purchase of insurance, and would be inconsistent with the traditional attempt to promote the purchase of such protection.

5. No penalty tax

Sun Life opposes the imposition of any penalty tax on distributions to policyholders prior to their reaching a statutory age (such as proposed in H.R. 3441). Although the annuity rules contain such a penalty, the unique role of life insurance in providing an economic safety net for dependents warrants more favorable treatment. The potential for abuse would be eliminated under the proposed distribution tax and the existing Section 7702 definitional provision. A tax penalty on distributions will discourage the purchase of insurance coverage, rather than merely curbing investment-oriented distributions on policies.

6. Prospective application

Finally, any legislative changes should not apply to policies in force. This Subcommittee reviewed the life insurance tax provisions both in 1984 and in 1986. The Subcommittee should not, after fully considering these issues as part of the 1986 Tax Reform legislation, seek to alter the tax consequences of contracts entered into in reliance on that earlier resolution of the tax issues surrounding these policies. Thus, new rules, if enacted, should apply only to distributions and loans from policies purchased after the effective date.

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